Episode #227: Why High-Income Earners Now Prefer the Front Door Roth Strategy

Video Transcription

Welcome back to "Money Script Monday." My name is Kyle. Today, we'll be talking about why high-income earners now prefer the front door Roth strategy.

I'd be willing to bet most of you aren't too familiar with this strategy, but more so familiar with the classic backdoor Roth IRA. Essentially, the backdoor Roth IRA enables high-income earners to fund indirectly a Roth IRA. This has been somewhat of a tax maneuver, part of tax planning 101 for high-income earners to shelter themselves against future tax rate increases.

However, with the Biden Build Back Better bill that's being proposed after-tax conversions, essentially backdoor Roth IRAs are on the chopping block altogether.

The purpose of this video is to shed some light on tax-free strategies or loopholes for high-income earners which can accomplish the same thing. That's known as the front door Roth strategy, where we're using a life insurance contract as the funding vehicle.

But why are we here to begin with? We all know that the Roth IRA is the best saving tool, saving account for retirement. I mean, we're funding after-tax dollars into this account. It's growing uninterrupted, tax-deferred, withdrawals are tax-free, and we're not subject to any required minimum distributions. However, there come some restrictions on who can actually participate.

If we look on over to my left, now using modified adjusted gross income limits, if you're a single filer making over $129,000 or married filing

jointly making over $204,000, you, unfortunately, can't and don't qualify to contribute to a Roth. But if you're under those thresholds, congrats, you can. And if you're under age 50, it's $6,000 a year. If you're over age 50, you get an extra $1,000, making a total of $7,000 to fund into a Roth IRA.

However, most of you watching today are high-income earners and you just can't contribute to one. Whether you work with a tax professional or an advisor, the popular go-to approach is what's called a backdoor Roth IRA.

This was established back in 2010 when Congress lifted the income limitation on conversions and ultimately allowed high-income earners to fund an after-tax, nondeductible traditional IRA; then, immediately after funding, converting that to a Roth IRA to then obviously build your money tax-free.

Now there's good and bad, of course. The good is that there are a number of investment options. Those dollars that you do convert into the Roth grow tax-deferred, tax-free of which you can then later take out and they're not subject to any required minimum distributions.

However, there are potential headwinds. It isn't essentially risk-free in a sense of when that conversion takes place because the IRS uses what's called a pro-rata rule, and we have to follow that rule.

What that means is at the time of conversion, the IRS is going to take a look at all of your traditional IRA accounts, whether pre-tax or after-tax. They're going to use that pro-rata, that ratio, in this case, 70% of an individual's traditional IRAs are pre-tax, 30% are after-tax. When you do decide to backdoor convert that money into a Roth, they're going to tell you that on the conversion, you will pay 70% or 70% of that conversion would be taxable to you.

A lot of people don't know that and a lot of people have to work with advisors on an annual basis to make sure they don't screw that up

because there are penalties if you do; on top of that complication and those headwinds is a five-year rule and access to the money. Unfortunately, you can't tap into that until age 59.5. If you did and you want to access your gains inside that Roth, you'd have to wait five years to do so.

There are additional stipulations. Then taking a step back, big picture, if you're a high-income earner making $200,000 a year this is a 2% to 3% transaction. Could it be insignificant there's a lot of work going on and it's just a small amount, to begin with, that's going to grow then tax-free?

Well, because of the risks with the Biden proposal eliminating this backdoor Roth, we're here to show you alternatives. In that alternative I spoke with earlier, instead, we're going to be funding a life insurance contract, and we named it the front door Roth. Essentially, we're doing the same thing with the end result of building tax-free future income, but we're doing this by using a life insurance contract, which is permanent.

The stipulation here is that we need to maximum fund this type of contract up to the internal revenue code. When we do that for the most optimal performance, we're going to be structuring the policy for the minimum death benefit. We're funding in the most amount of premium and solving for the least amount of death benefit. It could be counterintuitive.

Most people think that you want to buy the most amount of insurance for the least amount of premium. We're doing the opposite. When doing the opposite, we're able to grow more cash value inside the contract which we can then later tap into tax-free.

Now with anything, as we mentioned earlier, there are pros and cons to it and it's based on your situation. One of the first advantages are contractual guarantees. The biggest one is principle protection. Your money you put inside this contract sheltered not only against future tax

rate increases but also against market volatility. So you won't see those daily swings in the market affect your account.

The second is that, as I mentioned earlier, we have to follow those internal revenue codes. However, we set the bar; we're the ones that are able to determine how much we want to fund into this contract but make it internal revenue code compliant so we don't end up losing these tax advantages that we receive.

The third is access to capital. Everyone loves to stay liquid, and liquidity can be one of the most powerful tools to take advantage of opportunities in your life. You can do so without being penalized as you can't inside the Roth or the backdoor Roth. We can access those types of funds via withdrawals over cost basis, or simply just loans creating some form of an arbitrage so earning more than what we're being charged, so to speak.

Now, the headwinds are that this is a life insurance contract at the end of the day. You have to qualify medically. There will be possibly an exam where blood and urine would be required.

At the same time, our upside is limited. There are caps on our returns because of those contractible guarantees the insurance company's going to provide. It's a give and take. For our downside protection, they're going to limit some of our upside potential.

Lastly is a front-end cost structure. It's a little bit loaded upfront, but we know these are long-term plays. We're doing this 20, 30 years out to build a nest egg that's tax-free. Over time, the cost structure minimizes and is far less than what other contracts, what other wealth-building vehicles you can be using in retirement. So, it’s something to consider.

To tie a bow around this entire episode, we talked about why we're here and that's the Biden administration, potentially for the year 2022, eliminating this tax loophole known as the backdoor Roth IRA. What's

there to do? You have to have alternatives to grow your money tax-free and we showed you one.

It's a form of what we call a front door Roth strategy using a life insurance contract that's permanent of which we're going to set the bar. We're going to control the contribution and income limitations and we have to just make sure that we're following that internal revenue code.

So, if you have any questions, reach out to the financial advisor that shared this video. I'll leave you with one more question.

How much would you fund into a Roth if there were no income or contribution limitations?

Thanks, again. We'll see you next week. Enjoy your day.