CONDUIT IRA – IS IT REALLY NECESSARY?

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Conduit IRAs, sometimes called "rollover IRAs," typically contained only money rolled over from a company plan - and subsequent earnings on those dollars. But a 2001 tax law (Economic Growth and Tax Relief Reconciliation Act of 2001) opened all sorts of rollovers and plan portability. So, for the most part, a person could commingle his IRA contributions and rollovers from plans in the same IRA. The result was that, beginning in 2002, conduit IRAs were no longer necessary for most people rolling over plan funds. Yes, conduit IRAs were still necessary for anyone looking to preserve the extremely rare tax break for 10-year averaging, but essentially, conduit IRAs became superfluous.

Nevertheless, people continue to think that a conduit IRA will somehow allow them to dance around certain tax rules or save them when it comes to bankruptcy. Here are a handful of reasons why a conduit IRA is nothing more than an extra statement in the mail, and a couple of reasons why a conduit IRA could still provide some value.

Bankruptcy Protection. ERISA plans – like most 401(k)s - maintain unlimited bankruptcy protection. If you have $10 million in your 401(k) and file for bankruptcy, those plan assets are unavailable to your creditors. If you were to roll over those plan dollars to an IRA, the $10 million would maintain unlimited bankruptcy protection.

An IRA, on the other hand, has only an inflation adjusted cap of bankruptcy protection. This cap currently sits at $1,512,350 and covers your IRA contributions and earnings. Anything over this contributory cap could become available to your bankruptcy creditors. So, should you keep your $10 million rolled over from your 401(k) in a separate IRA – away from your contributory IRA dollars? Not necessary.

Commingling is allowed and will not impact the unlimited bankruptcy protection you still have on the former plan dollars. Those former plan dollars remain fully protected, and the $1,512,350 cap is still fully available for your contributory dollars.

After-Tax IRA Dollars/Basis. The Backdoor Roth strategy is alive and well. You can make after-tax (non-deductible) contributions to an IRA and then convert those dollars tax-free to a Roth IRA. However, the pro-rata rule applies. If you have any IRA (or SEP or SIMPLE) with pre-tax dollars, you cannot cherry-pick the after-tax dollars and only covert those. A separate IRA – possibly a conduit IRA where you rolled over your after-tax dollars from a former 401(k) – will not help. Segregating the after-tax from the pre-tax dollars in a different IRA has no bearing on pro-rata, so you might as well commingle.

Reverse Rollovers. Occasionally, employees will leave a job, roll over former plan dollars to an IRA, and then want to roll over those former plan dollars to a new plan at their new job. There is no rule that dictates former plan dollars must be segregated into their own conduit IRA before being rolled back to a new plan. Commingling is perfectly acceptable under the tax code. Now, a specific plan document could have some strange language that dictates that it will only accept former plan dollars via a reverse rollover. In such a case a conduit IRA would be necessary, but this is rare. Additionally, a conduit IRA could help - from an administrative standpoint - so an IRA owner can keep his accounts straight. Regardless, before opening that conduit IRA, ask yourself - is it really necessary?