BACKDOOR ROTH IRA CONTRIBUTIONS

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Funding a Roth IRA is the best way to minimize your tax burden and create tax-free income in retirement. However, investors with high incomes are not allowed to contribute directly to a Roth IRA. Even though the IRS has imposed income limits on Roth contributions, there is still a way to contribute indirectly. This strategy is referred to as a "Backdoor Roth IRA."

Income Limits

If your tax filing status is single and your adjusted gross income is above $161,000, you are phased out of making a direct Roth IRA contribution. If your tax filing status is married filing joint, that phaseout starts at $240,000.

What is a backdoor Roth IRA?

The first step in this process is to open a Traditional IRA if you haven't already. Then, you make a nondeductible contribution to the IRA. Usually, this amount would be deductible because an IRA is a pre-tax account. But the goal is to move money that has already been taxed to a Roth, so you do not want to take a deduction for this initial contribution.

After you have made your nondeductible contribution to your IRA, you can convert or move the funds to a Roth IRA. It's important to point out that a backdoor Roth IRA differs greatly from a Roth conversion. A conversion triggers a taxable event on the entire amount moved to the Roth. The backdoor strategy does not trigger a taxable event because taxes have already been paid on this money.

If you are opening up a Traditional IRA for the first time, the most you can contribute in 2024 is $7,000 if you are under 50. This means that you could only move over about $7,000, or whatever the annual limit is in a given year, at a time from the Traditional IRA to the Roth. But, if you already have a Traditional IRA funded with pretax dollars, this process may get a little more complex.

Tax Considerations

For the IRAs already funded with pretax money, you don't get to choose to convert only your nondeductible contributions. Instead, the tax liability on the conversion is based on a ratio of deductible contributions and earnings to nondeductible contributions across all of your IRA accounts. The IRS uses an IRA aggregation rule that views your Traditional IRAs as a single tax entity. So, if you have three IRA accounts, the IRS considers them one entity from which you are converting or moving money.

For example, suppose you have combined IRAs worth $100,000, composed of

10% in nondeductible contributions and 90% in deductible contributions. If you want to convert or move $10,000 (10%) to the Roth IRA, then 90% of the money you move would be taxable. So you would owe taxes on $9,000, or 90% out of the $10,000.

Pros & Cons

Considering whether a backdoor Roth IRA is the right strategy for you, consider these additional factors.

Pros:

- Roth IRAs do not have required minimum distributions, whereas Traditional IRAs do. This will be very helpful for income planning and tax planning in retirement.
- A Roth IRA can be helpful for estate planning. Spouses can roll an inherited Roth IRA into a Roth IRA in their own name.

Cons:

- If you convert money from a Traditional IRA funded with deductible and nondeductible contributions, you may be kicked into a higher tax bracket.
- Roth IRAs have a five-year holding period to be eligible for tax-free distributions. The amount you convert needs to stay in the Roth IRA account for five years before making a withdrawal, or else you will incur a 10% penalty. With direct Roth IRA contributions, you can generally withdraw contributions penalty-free. But for these back-door Roth IRAs, the five-year holding period applies to converted amounts.

This strategy is an excellent tool for investors disqualified from a direct Roth IRA contribution. A backdoor Roth IRA can provide high-income earners with the opportunity to maximize their tax savings in retirement. This approach can get very complex, so you want to make sure you're working with someone who can guide you through the process. If this is something you may consider in the future, it's essential to speak with an advisor about its impact on your financial situation.

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