Backdoor Roth IRAs

An IRS-Sanctioned Loophole

As you may know, the IRS restricts high income earners from directly contributing to a Roth IRA. Even if you fall under the income limits, the amount you can contribute per year is limited. However, the IRS does not restrict high income earners from making Roth conversions, and does not limit the amount that can be converted. This leaves the backdoor open for everyone to enjoy the tax-free growth and tax-free withdrawal benefits of Roth IRAs.

Backdoor Roth IRA Overview

- A "Backdoor Roth IRA" is not an official type of retirement account. Although not specifically referred to as a "Backdoor Roth IRA," it is an IRS sanctioned strategy that allows high income earners to fund a Roth IRA.
- For 2021, if your modified adjusted gross income is higher than $140,000 for a single person, or $208,000 for a married couple filing a joint tax return, you cannot directly contribute to a Roth IRA.
- Even if you can directly contribute to a Roth IRA, the amount you are able to contribute cannot exceed $7,000 for 2021 ($6,000 for those under 50).

How to Create a Backdoor Roth IRA

There are a few different ways you can create your own Backdoor Roth IRA. First, you can create a traditional IRA and then roll over the funds to a Roth IRA. You can also roll over an existing traditional IRA into a Roth IRA. As noted above, this rollover can be for as much as you want, even if it is more than the annual contribution limit. Lastly, you can make after-tax contributions to your 401(k) plan and then roll over these contributions into a Roth IRA.

Tax Considerations

- The amount converted from a traditional IRA to a Roth IRA will be counted as taxable income in the year it is rolled over. After these initial taxes are paid, the funds remaining in the Roth IRA grow tax-free and any gains will not be taxed upon withdrawal provided you have had your Roth IRA for at least 5 years and have reached age 59 ½. Roth IRAs also do not have required minimum distribution rules unlike a traditional IRA or 401(k).
- If your retirement account contains both before and after-tax contributions, a rollover from that account to a Roth IRA will be taxed on a pro-rata basis (in other words, you cannot roll over only the after-tax portion and avoid paying taxes on the rollover).
- Earnings withdrawn from the Roth IRA within five years after conversion are subject to a ten percent penalty from the IRS.

While the creation of a Backdoor Roth IRA may seem simple, there are many pitfalls that need to be avoided. Please consult a tax professional before implementing this strategy.

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