Contribute to a Roth IRA no matter your income

The backdoor Roth IRA strategy

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Many people think they are not able to contribute to a Roth individual retirement account (IRA) because of their income, but in fact they can through a backdoor Roth IRA strategy. While it may sound complex, we can help you understand the benefits of this strategy and how it works.

What is a backdoor Roth IRA strategy?

At its core, a backdoor Roth strategy is a way for high-income earners to replicate regular Roth contributions by making a nondeductible contribution to a traditional IRA and then converting it to a Roth IRA.

The backdoor Roth IRA strategy gets its name because making normal contributions to a Roth IRA isn't a given for all investors. Namely, if you earn more than the amounts to the right, you're either partially or completely phased out from making regular contributions to a Roth IRA.

Income limits for Roth IRA contributions

	Single	Married filing jointly
Beginning of income phase-out	$138,000	$218,000
Completely phased out of contributing	$153,000	$228,000

Source: The Internal Revenue Service. For 2023 tax year. Based on modified adjusted gross income (MAGI).

By executing this strategy, you can grow the dollar amount of tax-free assets you save for retirement. These funds also gain the other benefits of a Roth account, including no required minimum distributions (RMDs), a tax-free asset for your heirs and the ability to access contributions tax- and penalty-free before retirement.

While there can be benefits to pursuing a backdoor Roth IRA strategy, it can have an impact on your current and future taxes. Because of this, it is important to consult with your tax professional before pursuing this strategy to determine how it will affect your tax situation.

When to consider a backdoor Roth IRA strategy

A backdoor Roth could make sense for your situation if:

- You're contributing the maximum to your employer plan or, if not, you prefer the features of a Roth IRA, AND
- Your income prevents you from contributing directly to a Roth IRA, AND
- You have few or no pretax assets in any traditional IRA (including SEP and SIMPLE IRAs).

Correcting common misconceptions

- Even if you exceed the income threshold for contributing to a Roth IRA, you can still open a Roth IRA.
- While your income and access to an employer plan may limit your ability to make deductible contributions (i.e., pretax) to a traditional IRA, you can make nondeductible (i.e., after-tax) contributions to one as long as you have taxable compensation.
- Anyone, regardless of income or age, can convert funds from a traditional IRA to a Roth IRA.
- Unlike Roth IRAs, a direct contribution to a Roth employer plan (like a Roth 401(k)) isn't limited by your income. If you're not already contributing the maximum to your employer plan, consider contributing to your Roth employer plan before executing a backdoor Roth IRA strategy, unless you prefer the features of a Roth IRA.

How Roth IRA conversions are taxed

The backdoor Roth IRA strategy generally works best when you have few or no pretax funds or earnings in any traditional IRA prior to pursuing the strategy. The reasons for this are the Pro-Rata Rule and the Aggregation Rule.

The Pro-Rata Rule and the Aggregation Rule

If you have a mix of pretax and after-tax dollars in your IRA(s), then you will owe taxes for the percentage of your account that is made up of pretax amounts. This is known as the Pro-Rata Rule.

It's important to note that the IRS looks at all your traditional IRAs (SEP and SIMPLE included) when determining your allocation of pretax and after-tax dollars. This is known as the Aggregation Rule. So, even if you are converting funds from an IRA that does not have pretax money in it, you will still owe some taxes on the converted amount if you have another IRA with pretax funds.

Let's look at an example to see how this works: Lawrence is executing a backdoor Roth IRA strategy and currently has no pretax funds in any of his traditional IRAs. To execute the strategy, Lawrence makes a $6,000 nondeductible (after-tax) contribution to his IRA and converts it to a Roth IRA. Because all the funds in the traditional IRA were after-tax funds, the conversion does not have an associated tax bill.

Now let's look at the same strategy if Lawrence had $94,000 of pretax assets in his traditional IRA. When he makes a $6,000 after-tax contribution to the traditional IRA, the total account value will be $100,000, with 94% representing pretax funds and 6% after-tax funds.

Because Lawrence has pretax and after-tax funds in his IRA, he will need to determine how much of the conversion will be subject to taxes. In this case, $5,640 (94%) of the conversion will represent pretax funds (on which he will owe taxes) and $360 (6%) will be after-tax funds (on which he will not owe taxes). It's worth noting that earnings are treated as pretax amounts, even if they were on after-tax contributions.

As you can see from the two examples, there is a meaningful difference in the amount of the conversion that is subject to taxes. This is why the backdoor Roth IRA strategy generally works best when you have few to no pretax funds in any traditional IRA prior to pursuing the strategy.

Strategies for managing your conversion taxes

Isolating basis

If you already have substantial pretax IRA assets, you may be able to separate them prior to employing a backdoor Roth IRA strategy, which is known as isolating basis in an IRA. The primary way to do this when pursuing a backdoor Roth IRA strategy is by rolling funds into a 401(k) or another eligible employer plan.

Depending on the terms of your plan, you may be able to roll funds from your traditional IRA to your 401(k), which is sometimes called a reverse rollover. Because only pretax funds can be rolled into an employer plan, this strategy effectively allows you to isolate the basis (or after-tax portion) of the IRA. You can then convert the remaining after-tax contributions to a Roth IRA without an associated tax bill. This strategy isn't available to everyone, though.

Before executing this strategy, there are some things you should be aware of. If you would like to roll your funds back out of your 401(k) after you convert your after-tax IRA dollars, your plan might not let you do so until after you leave your employer, so make sure to check the rules of your plan.

Also, make sure to wait until the year after your Roth conversion to roll the funds back out. If you roll the pretax assets back into your IRA in the same year as your conversion, the pretax funds will be counted as part of the Pro-Rata Rule, since your pro-rata allocation is based on your year-end balances.

If you're pursuing a backdoor Roth strategy with substantial pretax assets that can't be separated, you'll want to consider strategies that are more aligned with a Roth conversion. Please see our Roth conversion report for more details.

Timing your conversion

Timing a backdoor Roth IRA strategy is of less importance when you have smaller amounts of pretax IRA assets. However, regardless of when you decide to execute the strategy during a given year, we recommend converting the after-tax funds close to the time when your nondeductible contribution is made, to minimize pretax earnings on the after-tax contributions and allow the funds the greatest amount of time to potentially grow tax free.

Paying for the taxes

As long as you have few to no pretax assets in your traditional IRAs, a backdoor Roth IRA strategy typically involves very little in taxes. However, if you do have to pay some taxes, we generally recommend to pay the taxes out of pocket (rather than having them withheld). Otherwise, you'll end up with less converted into your Roth IRA and miss the potential tax-free growth on those withheld funds, and you could owe a penalty on the withheld amount.

How distributions from a Roth IRA are taxed

Roth IRAs generally have favorable distribution rules that can help limit the taxes and penalties you pay on a distribution if you must pay them at all. When a distribution is taken from a Roth IRA, the funds are distributed in the following order:

1. *Regular contributions:* Can be distributed anytime without taxes or penalties.
2. *Taxable conversion contributions (oldest first):* Distributions will not be taxed but may be subject to penalties. Additional details below.
3. *Nontaxable conversion contributions (oldest first):* Distributions will not be subject to penalties or taxes.
4. *Earnings:* Distributions may be subject to taxes and penalties. Additional details below.

It's worth noting that a backdoor Roth IRA strategy is funded with after-tax funds, which fall under nontaxable conversion contributions when converted.

Taxable conversion contributions

Taxable conversion contributions will not be subject to taxes when distributed, because they were taxed when converted. The distribution will be subject to the 10% penalty if you have not met the five-year holding period requirement, are younger than 59½ and do not qualify for a penalty exception.

Earnings

To avoid taxes and the 10% penalty on a distribution of earnings, you need to satisfy two requirements:

1. The distribution must be made after the owner turns 59½, dies or becomes disabled, or for a qualified first-time home purchase (up to $10,000).
2. You must meet the five-year holding period requirement.

If you don't meet those requirements, there may be other exceptions that allow you to avoid the 10% penalty, but the distribution will still be subject to taxes if you don't meet the other two criteria.

The five-year holding period requirement

When satisfying the five-year holding period requirement, you should be aware that distributions of Roth earnings and taxable conversion contributions are treated differently. The five-year requirement for earnings starts the first year you fund any Roth IRA (your earliest funded Roth IRA satisfies this for all your Roth IRAs), and once the requirement is satisfied for earnings, it's always satisfied. So, if you first funded a Roth IRA on April 14, 2023 (which would count for the 2022 tax year), your holding period requirement would be satisfied on Jan. 1, 2027.

Taxable conversion contributions are different because you must meet the holding period requirement for each conversion you complete. For example, let's say you make a conversion in 2023 and another conversion in 2024. Your conversion amounts from the 2023 conversion can be withdrawn on Jan. 1, 2028, penalty free. The conversion amounts from your 2024 conversion can be withdrawn on Jan. 1, 2029, penalty free.

The deadline for a Roth conversion is also different. While the deadline for an IRA contribution to count for a tax year is the tax deadline (typically April 15 of the following year), the deadline for a conversion counting for a given year is Dec. 31.

The backdoor Roth IRA strategy: A way to increase your retirement savings

If you're unable to contribute to a Roth IRA directly, the backdoor Roth IRA strategy can be a powerful tool to help you increase the amount of tax-free assets you save for retirement. Talk with your financial advisor today about whether it fits within your financial strategy.

