

What is a backdoor Roth IRA?

"Backdoor Roth IRA" is a term that describes a strategy used by high-income earners who can't contribute to a Roth IRA because their income is above certain limits. Rather than contributing directly to a Roth, the backdoor strategy calls for contributing to a traditional IRA and then converting it to a Roth.

Roth IRAs are attractive because of their unique tax advantages. With a Roth IRA, you contribute after-tax dollars, and as long as you meet certain requirements, you can withdraw both the invested money (principal) and any earnings tax-free in the future. While you contribute the same dollar amount to the Roth IRA as you would a traditional IRA, the Roth can be more powerful over time because the entire balance—including all investment gains—can be withdrawn tax-free in retirement. Withdrawals on traditional IRAs, on the other hand, are taxed as ordinary income, which can be as high 37% at the federal level.

Plus, unlike traditional IRAs, Roth IRAs don't have required minimum distributions (RMDs), which gives you greater flexibility in retirement and potentially lowers your tax liability over your lifetime.

The challenge is that income limits prevent many high earners from contributing directly to a Roth IRA. A backdoor Roth IRA provides a workaround through a 2-step process: First you make a nondeductible contribution to a traditional IRA, meaning you don't get a break up front. Then you convert that contribution to a Roth IRA, in which future growth and qualified withdrawals can be tax-free.

This strategy works because while there are income limits for direct Roth contributions, anyone can convert a traditional IRA to a Roth IRA regardless of income level. Since the initial contribution is made with after-tax dollars, you typically won't owe additional taxes on the conversion (as long as you don't have other pre-tax traditional IRA assets, which would be taxable if converted). However, you will owe taxes on any gains that occur between making the contribution and the conversion. Those gains will be taxed as income when you convert. This strategy can be especially attractive for high earners who want to access tax-free growth, which they typically don't have access to due to income limits on direct Roth contributions.

A nonworking spouse can also use the backdoor Roth IRA strategy subject to the income limits based on the working spouse's income.

Contact Marino and Associates, if you have questions. 503-239-4716