Over the Roth IRA Income Limits? Use the Back Door!

Roth IRAs are considered a valuable way to save for retirement for a couple of reasons. First and foremost, they can provide tax-free income during your retirement years[1]. Roth IRAs are funded with after-tax dollars, and the earnings on your investments are tax deferred. Unlike traditional IRAs, Roth IRAs do not have required minimum distributions during your lifetime, so you'll never be forced to take money out if you don't want to[2]. That makes them a more beneficial way to transfer your wealth to your family or loved ones than a traditional IRA or 401(k).

Roth IRA Annual Contribution Limits

Not everyone can make annual contributions to a Roth IRA. The ability to contribute depends, in part, on having earned income, but also on your tax filing status and your modified Adjusted Gross Income ("AGI"). The inability to make Roth IRA contributions is typically because your income is higher than the IRS income limits.

Roth IRA Income Limits

	Tax Year	Single or Head of Household	Married, Filing Jointly	Married, Filing Separately**
Full Contribution if MAGI* is at or below:	2023	$138,000	$218,000	$0
	2024	$146,000	$230,000	$0
Partial Contribution if MAGI* is between:	2023	$138,000 - $153,000	$218,000 - $228,000	$0 - $10,000
	2024	$146,000 - $161,000	$230,000 - $240,000	$0 - $10,000
No Contribution if MAGI* is at or above:	2023	$153,000	$228,000	$10,000
	2024	$161,000	$240,000	$10,000

*Modified Adjusted Gross Income
**If married filing separately, and did not live with your spouse at any time during the year, see MAGI for Single or Head of Household

What do you do if you don't qualify to make a Roth IRA annual contribution? See if you can contribute through the back door!

[1] Tax-free qualified withdrawals from a Roth IRA can begin after 5 years and age 59 ½, disability, death or for a first-time home purchase.

[2] Required minimum distributions apply to inherited Roth IRAs but are generally income tax free for the beneficiaries receiving them.

Back-Door Roth IRA Strategy

A back-door Roth IRA strategy involves a few steps:

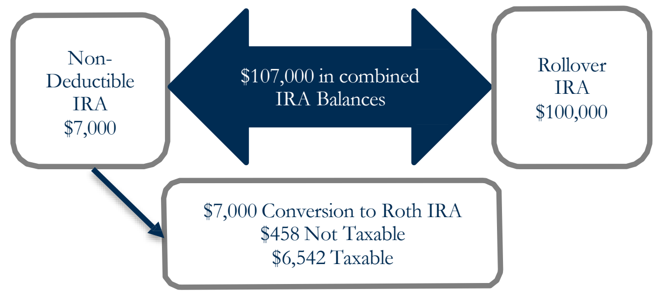
1. **You make a contribution to a traditional IRA.** To be eligible to contribute to the traditional IRA, you must have earned income (or be married and your spouse has earned income). If your modified AGI is too high to receive an income tax deduction for your traditional IRA contribution, and too high to fund the Roth IRA directly, that means your traditional IRA contribution is non-deductible and is being funded with after-tax dollars (basis). Basis is reported and tracked on IRS Form 8606.

2. **You convert your traditional IRA to a Roth IRA**. When you complete a Roth conversion, in most cases income tax liabilities will result. How much income tax you owe depends on if you have other IRA balances (including pre-tax deductible contributions, rollover contributions, SEP or SIMPLE IRA contributions) and if you have any earnings in the traditional IRA that have not been taxed.

The IRS Pro Rata Tax Calculation

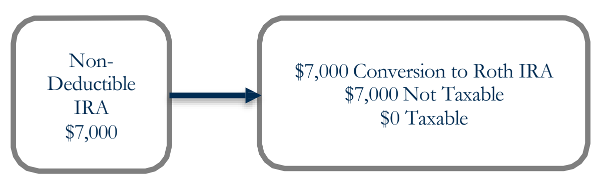
If you have any pre-tax balances in any IRAs that are held by you, even if they are not in the account you are converting, the IRS will require you to calculate the income tax due as if all IRA balances were held in one account. Therefore, when you convert, part of your conversion would include a return of your after-tax non-deductible contributions and part would represent your pre- tax dollars. If you have no other IRAs but the account you have funded with after-tax dollars, and you convert quickly so there are no earnings, the conversion would be income tax free.

Example 1: You have a $100,000 rollover IRA and make a non-deductible $7,000 contribution to a separate traditional IRA account. You immediately convert the $7,000 non-deductible IRA to a Roth IRA.



Even though you only converted the non- deductible traditional IRA, there will be income tax consequences from the conversion. Total IRA balances are $107,000 and only $7,000 is after-tax basis. Therefore, roughly 6.5% or $458 of the converted balance represents after-tax basis and 93.5% or $6,542 would be taxable. Basis remains in the traditional IRA for you to use in the future.

Example 2: You have no existing IRA account balances and open and fund a non-deductible traditional IRA with a $7,000 contribution. You immediately convert the $7,000 non-deductible IRA to a Roth IRA.



Because all $7,000 converted represents after-tax dollars, there is no income tax due for the Roth conversion.

Who Should Consider a Back-Door Roth Conversion Strategy?

Because conversion can create income tax liabilities, the strategy is not right for everyone. However, funding a Roth IRA through the back door reduces or, in some cases, eliminates the incomes taxes that result from a conversion. A back-door approach to a Roth IRA might make sense for you if:

- You have no other IRA accounts – no rollover IRA, traditional (deductible) IRA, SEP IRA or SIMPLE IRA account balances.
- Your income is too high to receive an income tax deduction for a traditional IRA contribution or to fund a Roth IRA.
- You have maxed out or do not have access to other pre-tax or deductible retirement savings accounts, such as a 401(k) or 403(b) plan.
- You desire tax-free income in retirement, or desire tax-free income for your heirs after death.

Also, keep in mind that a Roth conversion is a one-way street. You cannot reverse a Roth conversion so make sure you discuss any conversion strategy with your tax advisor before proceeding.

We are Here to Help

If you would like additional information on funding a Roth IRA through the back-door, about Roth IRAs, or about retirement savings in general, contact a financial advisor today. ■