 By: Denise Appleby, CISP, CRC, CRPS, CRSP, APA

help@applebyconsultinginc.com | https://applebyconsultinginc.com

How The Backdoor Roth IRA Contribution Works

If you believe that income tax rates will increase in the future- as many finance and tax experts do- then you will agree that the Roth IRA is often a better choice than the traditional IRA, if the objective is to choose the one that results in the lower income tax. But what if you are not eligible to make a regular contribution to a Roth IRA, because your income is too high? You can get around that limitation by using the backdoor Roth IRA contribution strategy.

Why Roth IRAs Are Attractive

Like traditional IRAs, earnings in Roth IRAs grow tax-deferred. But unlike traditional IRAs, where distributions of earnings are subject to ordinary income taxes, distributions of earnings from a Roth IRA are tax-free as long as you are eligible for a qualified distribution.

Your distributions would be qualified if you meet the following two requirements:

- 1. The distribution is made from any of your Roth IRAs, five or more years after you funded your first Roth IRA. And,
- 2. The distribution is made when you are at least age 59½ or disabled, or for first-time homebuyer purposes. The first-time homebuyer amount is limited to $10,000 over your lifetime.

Of course, like any other financial planning strategy, a Roth IRA is not a one-size-fits-all solution. Therefore, a suitability assessment should be done to determine if the Roth IRA is the right choice for you. Consult your financial or tax advisor for assistance with determining your Traditional vs. Roth suitability.

The Income Limitation On Roth IRA Contributions

One of the ways in which a Roth IRA can be funded is by making regular IRA contributions. Unlike traditional IRAs which are not subject to income limits, you are eligible to make a contribution to a Roth IRA only if your modified adjusted gross income (MAGI) does not exceed the following amounts:

2018 MAGI Limits

- $135,000 or more, if your tax filing status is Single
- $199,000 or more, if your tax filing status is Married Filing Jointly
- $10,000, if your tax filing status is Married Filing Separately

2019 MAGI Limits

- $137,000 or more, if your tax filing status is Single
- $203,000 or more, if your tax filing status is Married Filing Jointly
- $10,000, if your tax filing status is Married Filing Separately

But this limitation can be circumvented, as long as you are under age 70½ by the end of the year for which you want to make the contribution. This circumvention method is commonly referred to as a backdoor Roth IRA contribution.

The Two Steps To A Backdoor Roth IRA Contribution

The backdoor Roth IRA contribution is a strategy and not a product or a type of IRA contribution. Therefore, you shouldn't ask your IRA custodian or trustee for a backdoor Roth IRA contribution. Instead, you should take the following steps:

Step 1: Make Your Contribution To A Traditional IRA

Remember, you are eligible make a contribution to a traditional IRA, only if you are under age 70½ as of the end of the year for which you make the contribution. For instance, you are eligible to make a regular contribution to a traditional IRA for 2019, only if you will not reach age 70½ on December 31, 2019. You are considered to have reached age 70½ six months after your 70th birthday.

Your regular IRA contribution cannot exceed the lesser of:

- $5,500 for 2018/ $6,000 for 2019 or,
- 100% of your eligible compensation received for the contribution year. Eligible compensation generally includes amounts that you receive for working- such as salary and self-employment income.

If you are at least age 50 by the end of the year, you are eligible to make an additional catch-up contribution of $1,000.

Reminder: Your IRA contribution must be made by your tax filing due date. Generally, extensions do not apply.

Tip: Reporting Nondeductible Traditional IRA Contributions

If you and/or your spouse- if married- are not covered under an employer sponsored retirement plan- such as a 401(k) or defined benefit pension plan for the contribution year, you are eligible to claim a tax deduction for your traditional IRA contribution. If you and/or your spouse- if married- are covered under an employer sponsored retirement plan, your eligibility to claim a deduction for the contribution depends on your modified adjusted gross income (MAGI). Your tax preparer should help you to determine if you are eligible to claim a tax deduction for your traditional IRA contribution, and if so, whether you should claim that deduction.

If no deduction is claimed for the traditional IRA contribution, IRS Form 8606 should be filed to report and track the amount, so that any distribution or Roth conversion of the amount is nontaxable.

Step 2: Convert The Contribution To A Roth IRA

Notify your IRA Custodian/Trustee that you want to convert your traditional IRA contribution to a Roth IRA, and follow their instructions for doing so. This will result in the amount being moved to your Roth IRA, technically, resulting in you making a Roth IRA contribution, albeit through a 'back door.'

If you have basis in your traditional IRA, whether from any nondeductible traditional IRA contributions or rollover of after-tax amounts from an employer plan such as a 401(k), the Roth conversion will include a pro-rated amount of your basis and your pre-tax balance. Only the pre-tax amount would be taxable. For this purpose, all your traditional IRAs, SEP IRAs and SIMPLE IRAs are treated as one traditional IRA.

If you have no basis in your traditional IRA, then your Roth IRA conversion will include only the pre-tax amount and therefore fully taxable. Your IRA custodian/trustee will report your Roth conversion as fully taxable even if a portion of the amount is attributed to basis and should be tax-free. This is because they have no way of knowing how much of the amount is attributed to basis. However, your tax preparer is required to file IRS Form 8606 to let the IRS know how much of the conversion includes basis.

Keep A Record Of Your Roth IRA Activity

If this is your first Roth IRA, keep track of the year, so that you will know when your five-year period for 'qualified distribution eligibility' begins and how much of your Roth IRA balance is attributed to basis. You should also ensure that IRS Form 8606 is filed for every nondeductible contribution that you make to your traditional IRA, and for every distribution that occurs when any of your non-Roth IRA balances include basis.

Denise Appleby is CEO of Appleby Retirement Consulting, Inc., a firm that provides a wide range of retirement products and services to financial, tax, and legal professionals. The firm's primary goal is to help prevent mistakes from being made with retirement account transactions; and, where possible, provide solutions for mistakes that have already been made. Their products include IRA guides and other IRA educational tools for financial and tax professionals.

Denise is also creator and CEO of the consumer education website [https://www.retirementdictionary.com.](https://www.retirementdictionary.com)