

# THE BACKDOOR ROTH IRA GUIDE

A retirement strategy for high earners

## Introduction: Why the Backdoor Roth Exists

A **Roth IRA** offers tax-advantaged retirement savings. Your contributions are made with after-tax dollars, but your earnings and withdrawals in retirement are *tax-free*. This can be a powerful tool for building wealth.

However, the IRS imposes **income limits** on who can contribute directly to a Roth IRA. For 2024, if your modified adjusted gross income (MAGI) is above \$161,000 as a single filer or \$240,000 as a married filing jointly, you can't contribute directly.

That's where the **Backdoor Roth IRA** comes in. It's a workaround that allows high-income earners to sidestep these income limits and still benefit from a Roth IRA.

## How a Backdoor Roth Works

The Backdoor Roth IRA is a simple two-step process:

1. **Contribute to a Traditional IRA:** You make a non-deductible (after-tax) contribution to a Traditional IRA, regardless of your income. There are no income limits.
2. **Convert to a Roth IRA:** You then convert the funds from your Traditional IRA to a Roth IRA. This conversion is generally a taxable event, but if you have no pre-tax money in any Traditional IRA, the tax impact is minimal.

### Standard vs. Mega Backdoor Roth

The standard backdoor Roth involves contributing the annual IRA limit (\$7,000 in 2024, \$8,000 if age 50 or older) to a Traditional IRA and then converting it to a Roth IRA.

A *Mega Backdoor Roth* is only available through certain employer-sponsored retirement plans (like 401(k)s) that allow after-tax contributions beyond the regular contribution limits. These contributions can then be converted to a Roth IRA, allowing for much larger Roth contributions. This guide focuses on the *standard* Backdoor Roth IRA.

## Step-by-Step Process

1. **Open a Traditional IRA:** If you don't already have one, open a Traditional IRA account at a brokerage firm. Ensure you *do not* deduct the contributions.
2. **Contribute After-Tax:** Make a non-deductible contribution to your Traditional IRA. For 2024, the maximum contribution is \$7,000 (or \$8,000 if you're 50 or older).
3. **Convert to Roth IRA:** Initiate a Roth IRA conversion with your brokerage. This involves transferring the funds from your Traditional IRA to your Roth IRA. Time is of the essence here. Complete the process as soon as possible.
4. **File Forms:** When you file your taxes, you'll need to complete IRS Form 8606 to report the non-deductible contributions and the Roth conversion. Make sure your tax filing is accurate.

## Avoiding Common Pitfalls

- **Pro-Rata Rule:** This is the biggest potential issue. The pro-rata rule states that if you have *any* pre-tax money in *any* Traditional IRA (including SIMPLE, SEP, or Rollover IRAs), a portion of your conversion will be taxed. The taxable portion is determined by the ratio of your pre-tax IRA assets to your total IRA assets. **Cleanse Your IRA:** If you have pre-tax funds, consider rolling them into a 401(k) to avoid the pro-rata rule.
- **Penalties:** Ensure contributions do not exceed the maximum allowed amount, or you will incur penalties for overcontribution.
- **Timing:** Convert your money quickly after contributing to the traditional IRA. This minimizes any gains that would be taxable upon conversion.
- **Overcontribution:** Be aware of the annual contribution limits and avoid exceeding them. If you contribute too much, you'll need to withdraw the excess amount and any earnings on it to avoid penalties.

## Tax Implications

The Backdoor Roth IRA primarily has federal tax implications. However, some states may also have specific rules. The conversion from a Traditional IRA to a Roth IRA is generally a taxable event at the federal level, but as previously mentioned this is minimal if you have no other funds in a Traditional IRA.

**Tracking Basis:** Keep detailed records of your non-deductible contributions to your Traditional IRA. This is your *basis*, and it's essential for calculating the taxable portion of any future conversions or withdrawals.

**Avoiding Double Taxation:** By properly tracking your basis and filing Form 8606 correctly, you can ensure that you're not taxed twice on the same money. You've already paid taxes on the money you contributed to the Traditional IRA, so you only want to pay taxes on any earnings generated *before* the conversion to the Roth IRA.

## Advanced Strategies

- **Spousal IRA:** If your spouse doesn't work or has limited income, you can contribute to a Spousal IRA on their behalf, even if you're already maxing out your own contributions.
- **Rollovers:** As noted above, if you have pre-tax money in traditional IRAs, consider rolling over these funds into a 401(k) or other qualified retirement plan *before* completing the Roth conversion to avoid the pro-rata rule.
- **Timing:** Generally, it's best to convert early in the year to give any growth a longer tax-free runway within the Roth IRA. However, monitor market conditions and consider converting after market dips to minimize the taxable amount.

## Real-World Scenarios

- **High-Income Employee:** John earns \$200,000 per year. He can't contribute directly to a Roth IRA. He makes a \$7,000 non-deductible contribution to a Traditional IRA and immediately converts it to a Roth IRA. He completes Form 8606 when filing his taxes.
- **Business Owner:** Sarah runs a successful consulting business. She has a SEP IRA with substantial pre-tax funds. Before doing a backdoor Roth IRA, she rolls the SEP IRA into her solo 401(k) to avoid the pro-rata rule.
- **Married Couple:** Mark and Lisa both have high incomes. They each contribute \$7,000 to Traditional IRAs and immediately convert them to Roth IRAs. They file separate Form 8606 forms.

## FAQs

- **Can I use the Backdoor Roth every year?** Yes, as long as you meet the requirements (primarily, having income above the direct Roth IRA contribution limits).
- **What if the law changes?** Tax laws are subject to change. Stay informed about any updates that may affect the Backdoor Roth IRA strategy.
- **Is there an age limit?** No, there's no age limit to contribute to or convert to a Roth IRA.
- **What's the 5-year rule?** The 5-year rule applies to Roth IRA conversions. To avoid penalties on withdrawals of earnings from the converted funds, you must wait five years from January 1st of the year of the conversion. This also applied to those over 59 1/2 years old.

## Your Next Step

Ready to take control of your retirement savings? Contact us today for a personalized consultation.

Spark Wealth Advisors  
(904) 853-1068

info@sparkwealthadvisors.com  
www.sparkwealthadvisors.com



*Disclaimer: This guide is for informational purposes only and does not constitute financial advice. Consult with a qualified financial advisor before making any investment decisions.*