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Backdoor Roth

A **Backdoor Roth IRA** is a strategy that allows high-income earners who exceed the income limits for direct Roth IRA contributions to still enjoy the benefits of a Roth IRA. Here's how it works:

Step-by-Step Process for a Backdoor Roth IRA

1. **Contribute to a Traditional IRA**: First, make a non-deductible contribution to a Traditional IRA. As of 2024, you can contribute up to $6,500 per year (or $7,500 if you're 50 or older). This contribution isn't tax-deductible since you're likely over the income limit for deductible IRA contributions.
2. **Convert the Traditional IRA to a Roth IRA**: Once the contribution is in the Traditional IRA, you can convert the amount to a Roth IRA. There are no income limits for conversions, so you can do this regardless of your income.
3. **Pay Taxes on Any Gains**: If your Traditional IRA contribution grew before you converted it to a Roth IRA, you'll owe taxes on the gains. If you convert immediately, there likely won't be any growth, and thus no taxes due on the conversion.

Important Considerations

- **Pro-Rata Rule**: The IRS views all your Traditional IRAs as one when calculating taxes on a conversion. If you already have pre-tax money in a Traditional IRA, SEP IRA, or SIMPLE IRA, the IRS will apply the **pro-rata rule** to your conversion. This means that any pre-tax funds in those accounts will be considered proportionately when calculating the taxable amount on your conversion. To avoid this, some people try to "clear out" other IRA accounts by rolling them into a 401(k) before doing a Backdoor Roth conversion.
- **5-Year Rule**: Each conversion to a Roth IRA has its own 5-year clock for penalty-free withdrawals on converted amounts. If you convert and then withdraw before five years, you may face penalties if you're under age 59½.

Example of a Backdoor Roth IRA

1. **Contribution**: You contribute $6,500 to a Traditional IRA in 2024. Because your income is too high, this contribution is non-deductible.
2. **Conversion**: Shortly after making the contribution, you convert the entire $6,500 to a Roth IRA. If you convert before any earnings accrue, there are no taxes due on the conversion.
3. **Outcome**: Now, your funds are in a Roth IRA, where they can grow tax-free, and withdrawals in retirement will also be tax-free (as long as you meet the Roth IRA withdrawal rules).

The Backdoor Roth IRA is a legal and commonly used strategy by higher-income earners to gain access to tax-free growth and withdrawals in retirement. However, it can be complex if you have other Traditional IRA funds, so it's wise to consult a tax advisor before executing this strategy.

You can roll over (convert) Traditional IRA funds into an **existing Roth IRA** or a **new Roth IRA**—either option is allowed. The IRS doesn't require that the Roth be a new account, so if you already have a Roth IRA, you can simply convert your Traditional IRA funds into that existing account.

Key Points to Keep in Mind

- **Tracking Conversion Contributions**: If you use an existing Roth IRA, keep track of your contributions and conversions separately for record-keeping, especially for tax purposes and to manage the 5-year rule on converted funds.
- **Pro-Rata Rule**: If your Traditional IRA has both pre-tax and after-tax contributions, the IRS considers the entire Traditional IRA balance when calculating taxes owed on conversions (the pro-rata rule), regardless of whether you're converting to an existing or new Roth IRA.

Using an existing Roth IRA can simplify your account structure, while opening a new Roth IRA for conversions can help segregate converted funds, which may make tax tracking easier. Either way, you'll get the same tax benefits of tax-free growth and qualified withdrawals from your Roth IRA.

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Sincerely,

Matthew Powell

Owner, Powell United Financial Services