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TRICKS OF THE TRADE

"BACKDOOR ROTH IRA"

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The "Backdoor" Roth IRA is a nickname given to a specific tax loophole that was born in 2010. In that year, the Federal tax laws were changed which eliminated the income limit (formerly $100,000 AGI) to ***convert*** IRA assets to a Roth IRA. However, the income restrictions for ***contributing*** to a Roth IRA remained in place.

Meanwhile, an individual whose income was too high to contribute to a Roth IRA was not excluded from contributing to a Traditional (but non-tax-deductible) IRA. Thus, that same person contributed to an IRA, and then immediately converted that IRA to a Roth IRA. That individual was responsible for paying tax on any portion that was previously tax-deductible, or tax deferred, but there wasn't any! Thus, that individual effectively contributed to a Roth IRA, despite not being eligible based on his /her income. And voila, the Backdoor Roth IRA was born!

I discovered this loophole in January 2010, but it seemed too good to be true, so I ran it by the CPA I use for my taxes. He liked and agreed with my idea, but refined it with what I reference as the "pro rata rule". In short, the pro rata rule specifies that the amount of the Roth IRA conversion that is tax-free must take into account the total amount of IRA assets held by that individual. Thus, individuals who own IRAs may not be able to take full advantage of this Backdoor Roth IRA.

Speak with your tax preparer or financial advisor to see if the Backdoor Roth IRA makes sense for you.

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