The Backdoor Roth IRA

In a typical Traditional IRA, a taxpayer makes tax deductible contributions (i.e., pre-tax contributions), the investment growth is tax deferred and the money is subject to ordinary income tax when withdrawn. High-income earners are disallowed from making pre-tax contributions to a Traditional IRA if 1) their modified adjusted gross income exceeds certain thresholds, and 2) they are covered by an employer sponsored retirement plan. Taxpayers who are ineligible to make pre-tax contributions to a Traditional IRA can still make contributions, but these contributions are treated as non-deductible contributions.

The Roth IRA consists of after tax money, but the investment earnings grow tax-free and withdrawals are tax-free. High-income earners are disallowed from making contributions to a Roth IRA when their modified adjusted gross income exceeds certain thresholds. Beginning in 2010 Congress changed the rules governing the conversion of a Traditional IRA to a Roth IRA by eliminating the income restrictions and allowing all taxpayers, regardless of income, the ability to convert their Traditional IRA to a Roth IRA. The price a taxpayer pays for converting a Traditional IRA to a Roth IRA is ordinary income on the entire account balance on the date of the conversion.

For high-income earners who are not eligible to make regular Roth IRA contributions, they can make non-deductible contributions to a Traditional IRA and then convert to a Roth IRA. The conversion results in ordinary income taxes only on the amount in excess of the taxpayer's non-deductible contributions. There are a few potentials issues to be concerned with:

1. **The Aggregation Rule.** If the taxpayer has other pre-tax Traditional IRA money, they will have to pay tax on the converted IRA on a pro-rata basis. For example, if a taxpayer has a Traditional IRA with $95,000 of money from a 401(k) rollover (the $95,000 contributions were made on a pre-tax basis), and the taxpayer makes a $5,000 non-deductible contribution to a new Traditional IRA, the conversion would be 95% taxable. This can be avoided by rolling the $95,000 Traditional IRA into the taxpayer's employer sponsored retirement plan. Not all custodians allow this type of rollover.
2. **Form 8606.** Taxpayers who make non-deductible contributions to a Traditional IRA and/or convert a Traditional IRA to a Roth IRA must file Form 8606.
3. **The Step-Transaction Doctrine.** The step transaction doctrine is the legal principle that a series of related steps in a transaction should be combined to one single step and taxed based on the overall economic nature of the transaction, not taxed based on the separate individual steps. The concern is that the IRS would treat the converted amount as a direct contribution to the Roth IRA. The IRS's informal position is that the Backdoor Roth IRA strategy is not a problem. Congress expressly eliminated the conversion income limitations, allows non-deductible contributions, and allows taxpayers to convert Traditional IRAs to Roth IRAs. To minimize the potential that the separate steps may be re-characterized as a single step, taxpayers should wait some time between the contribution to the Traditional IRA and the conversion to the Roth IRA.

The Roth IRA is the most tax advantageous investment vehicle allowed by the government. Amounts in the account grow tax-free and can be withdrawn tax-free. In addition, amounts withdrawn are not counted for purposes of calculating Medicare premiums and do not affect the threshold for the new 3.8% Medicare contribution tax. Prior to engaging in this strategy, a number of factors must be taken into account including, other Traditional IRA assets, state tax issues, and potential IRS scrutiny of the transaction.

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