Take-Away:

Background: In 2024, the ability to make a Roth IRA contribution is limited by an individual's earnings. Their eligibility to contribute to a Roth IRA is phased-out depending on their adjusted gross income. For those who are married and filing jointly, the phase-out range for their eligibility to contribute to a Roth IRA is between $230,000 and $240,000. For single individuals, the phase-out range for their eligibility to contribute to a Roth IRA is between $146,000 and $161,000. To circumvent these income eligibility limits, an individual should consider implementing a *backdoor Roth IRA conversion* strategy.

Backdoor Roth IRA Conversion: To implement this backdoor strategy, an individual makes a nondeductible traditional IRA contribution. Those funds are then converted to a Roth IRA. The strategy works because there are neither income limitations for traditional IRA contributions nor Roth IRA conversions as there are for contributions made directly to a Roth IRA. There a couple of concerns implementing a *backdoor Roth IRA conversion* to be wary of: (i) the *earned income* rule; and (ii) the *pro-rata* rule, aka the 'cream in the coffee' rule.

> **Earned Income Rule:** The individual, or their spouse, must have earned income, such a wages or self-employment income. Since the *backdoor* strategy starts with a nondeductible contribution to a traditional IRA, there must be earned income. In other words, this contribution is subject to all the normal IRA contribution rules, including that earned income is required. Fortunately, a non-earning spouse can use their working spouse's earned income to make his/her own IRA contribution.
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> **Example:** Joe, age 81, is still working and married. Joe's wife, Jill, is age

75 and retired. Joe will earn $40,000 in 2024. Their other source of joint income exceeds the Roth IRA contribution limits for married individuals who file jointly. Joe can contribute $8,000 (which includes the $1,000 'catch-up' contribution) to a nondeductible traditional IRA. Jill can contribute $8,000 to her own nondeductible traditional IRA, even though she has no earnings. Jill can use Joe's earnings if they are married, and they file a joint income tax return. Once Joe and Jill contribute to their nondeductible traditional IRAs, they can each convert those IRAs to Roth IRAs, thus shifting $16,000 in the aggregate to their respective Roth IRAs.

Pro-rata Rule: A *backdoor* Roth IRA conversion is treated as a distribution from a traditional IRA followed by a conversion deposit to the Roth IRA. Whenever the IRA owner takes a distribution for their traditional IRA, all the owner's traditional IRAs, including SEP IRAs and SIMPLE IRAs are included in the pro rata calculation that is used to determine how much of the distribution is tax-free. When an IRA contains both nondeductible and deductible contributions, then each dollar that is withdrawn from any IRA will contain a combination of tax-free and taxable funds, based on the percentage of after-tax funds to the entire balance of *all* the owner's IRAs. This pro rata rule is sometimes called the 'cream in the coffee' rule, since once cream is added to the coffee, there is no way to separate the cream from the coffee.

Example: Margery, age 42, is now single and her income is too high for her to contribute direct to a Roth IRA for 2024. Margery decides to use the *backdoor Roth IRA conversion* strategy. Margery makes a nondeductible contribution of $7,000 to a traditional IRA and she then converts the funds to a Roth IRA. Unfortunately, Margery also has a SIMPLE IRA from her prior employer with a balance of $7,000 which represents her pre-tax contributions. Because of the presence of Margery's pre-tax SIMPLE IRA, her *backdoor Roth IRA conversion* will be partially taxable because of the pro-rata rule. 50% will be treated as a taxable distribution to Margery.

Five-Year Rules: Even with a *backdoor Roth IRA conversion* the owner still

must deal with the two 5-year rules associated with Roth IRAs. The 5-year rule, which applies to all Roth IRAs, provides that in most cases, even if the owner is older than age 59 ½, he/she generally cannot withdraw Roth IRA *earnings* free of taxes (or penalties) unless the owner's first contribution to the Roth account was made at least 5 years previously. The Roth IRA owner is allowed to withdraw *contributions* from his/her Roth IRA at any time, free of penalties or taxes.

There is a second 5-year rule for *backdoor Roth IRA conversions*. Because a *backdoor Roth IRA conversion* is categorized as a conversion and not a contribution, the Roth owner cannot access any of the funds held in the converted Roth IRA without penalty for the first five years after conversion. If a *backdoor Roth IRA conversion* is done each year, the owner must wait 5 years to access each portion that is converted. Otherwise, the Roth IRA owner risks paying additional penalties on money that has already been taxed. There are a couple of exceptions to this 5-year wait requirement: the Roth IRA owner is older than age 59 ½; the owner is disabled; or the owner dies.

Conclusion: A *backdoor Roth IRA conversion* should be of interest to high earners who do not qualify to contribute under the current Roth IRA earned income rules, those who can afford the additional taxes involved in a Roth conversion and who want to take advantage of future tax-free growth with the Roth IRA, and retirees who want to avoid required minimum distributions. Balanced against these benefits are investors who will need to use Roth IRA funds within 5 years and those with other traditional IRAs where they will have to navigate the *pro rata* rule which could trigger tax consequences that outweigh the benefits of the *backdoor Roth IRA conversion*.