Ultimate Guide To Backdoor Roth IRAs

Most investors pay too much in taxes… without ever realizing it.

As the old saying goes, you can’t eat pre-tax returns. Yet most investors focus exclusively on that metric.

What really matters – what we’re left with at the end of the day – is what I call “triple net returns.” In other words, **the return that’s left after fees, inflation, and taxes**.

As a pioneer in the ETF industry, I’m a big proponent of avoiding unnecessary fees. If you’ve downloaded this guide, I’m guessing that you’re already pretty conscious of fees.

While it’s important to be aware of the impact of inflation, it’s somewhat out of our control. Investors can tilt their portfolios towards assets that have historically performed well during inflationary periods, but that certainly doesn’t guarantee performance or protection, and has a relatively limited impact overall.

The biggest opportunity that most investors have to generate alpha in their portfolios comes from improving tax efficiency. There are a number of impactful, easy, low risk strategies that can increase deductions today, enable tax free growth in coming years, and allow for tax free withdrawals later in life.

This guide covers the Backdoor Roth IRA, a powerful strategy for high earners who otherwise wouldn’t be allowed to make use of the Roth structure.

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Backdoor Roth IRA In A Nutshell

Below is a summary of the key points of the Backdoor Roth IRA. This guide will then cover each of these areas in more detail.

1. For high earners who are not able to contribute directly to a Roth IRA, the Backdoor Roth allows you to achieve the same end result by making a nondeductible (i.e, after tax) contribution to a Traditional IRA, and then immediately converting to a Roth IRA. If done correctly, this conversion is nontaxable.
2. Tax free wealth is created by moving assets from a taxable account to a Roth IRA, where they can grow tax free and be withdrawn tax free.
3. The Backdoor Roth is a powerful tool because it is easy and low risk. Additionally, this is a recurring strategy; it can be completed every year, and couples may execute two Backdoor Roth contributions each year.
4. Complexities may arise for investors who have large balances in Traditional, SEP, or SIMPLE IRAs. For these investors, the Backdoor Roth may be a taxable event. Depending on individual circumstances, a Traditional-to-Roth Conversion may or may not be a good idea (the calculator below can help you determine whether it makes sense for you).

How To Execute The Backdoor Roth IRA

The Backdoor Roth involves making nondeductible, or after-tax, contributions to a Traditional IRA and then converting that IRA to a Roth IRA. If done correctly, in the order summarized below, this is a nontaxable event.

Step 1: Zero Out Any Non-Roth IRAs

A Backdoor Roth IRA involves converting a Traditional IRA to a Roth IRA. If you have balances in any non-Roth IRAs — including Traditional, SEP, or SIMPLE IRAs — you may incur a tax liability when attempting to do a Backdoor Roth. For most investors, there are two ways to zero out a non-Roth IRA: 1) convert it to a Roth (typically a taxable event); 2) roll the non-Roth IRAs into a Traditional 401(k).

Step 2: Make Nondeductible Contribution to Traditional IRA

The next step in a Backdoor Roth contribution is to make a nondeductible contribution to a Traditional IRA. As of 2023, the maximum contribution amount is $6,500 ($7,500 for over 50). To simplify the process, leave the contribution in cash or money market accounts (i.e., don’t invest it in stocks or bonds).

Step 3: Convert Traditional IRA to Roth IRA

Next, convert the Traditional IRA to a Roth IRA. Depending on your brokerage, you may need to wait a day or two to convert. This should be a fairly straightforward process (see Vanguard instructions here).

Step 4: Pay Taxes ($0) Incurred By Conversion

This is the beauty of a properly executed Backdoor Roth IRA contribution. If you have no other non-Roth IRA balances, you will owe taxes only on the difference between the amount you are converting and total nondeductible contributions made. Because you zeroed our your non-Roth IRA balances in Step 1, the Traditional IRA that you funded in Step 2 consists entirely of nondeductible contributions. In other words, you owe $0 in taxes.

Step 5: File Form 8606 With Your Taxes

You'll need to file one Form 8606 for each investor who completes a Backdoor Roth IRA (i.e., if you and your spouse both do a Backdoor Roth, you'll need to complete a form for each. This form is fairly straightforward, and you can see a sample form here.

Backdoor Roth Eligibility

The Backdoor Roth IRA should be used by investors who:

1. **Have Sufficient Earned Income.** In order to make a contribution to your IRA, you must have sufficient earned income. As of 2023, this means $6,500 for those under 50 (and $7,500 for those above 50).

2. **Can't Make Direct Roth Contributions or Deductible Traditional IRA Contributions.** This describes most HNW investors. Additional details on the Modified Adjusted Gross Income (MAGI) thresholds are included below.

3. **Don't Have Significant Traditional IRA Balances.** A Backdoor Roth involves converting a Traditional IRA to a Roth IRA. Upon conversion, investors will typically owe taxes on any Traditional IRA value greater than the nondeductible contributions they've made. So, if you've previously made deductible contributions to a Traditional IRA and/or rolled a 401(k) into your Traditional IRA, converting to a Roth IRA (i.e., executing a Backdoor Roth), will result in taxes. Read on for more information about the "pro rata" rule, as well as a calculator to help you determine the tax bill you would incur.

IRA Contribution Limits (2023, Married Filing Jointly)

As mentioned above, the Backdoor Roth is ideal for high earners who aren't eligible to make a "regular" or "direct" contribution to a Roth IRA or tax deductible (i.e., pre-tax) contributions to a Traditional IRA. The tables below show the income limits for married couples filing jointly:

Roth IRA Limits 2023, Married Filing Jointly
Under $218,000: Full Contribution Allowed
Between $218,000 and $228,000: Partial Contribution Allowed
Above $228,000: No Contribution Allowed

Traditional IRA Limits [a] 2023, Married Filing Jointly
Under $116,000: Full Deduction Allowed
Between $116,000 and $136,000: Partial Deduction Allowed
Above $136,000: No Deduction Allowed

[a] The limits in this table apply if you are covered by a retirement plan such as a 401(k) at work. If you're not but your spouse is, replace $116,000 with $218,000 and replace $136,000 with $228,000. If neither you nor your spouse is covered by a retirement plan at work, the full deduction is allowed.

If your income level is in one of the highlighted boxes above, a Backdoor Roth IRA is probably a good idea.

IRA Contribution Limits (2023, Single)

The tables below show the income limits for single taxpayers:

Roth IRA Limits 2023, Single
Under $138,000: Full Contribution Allowed
Between $138,000 and $153,000: Partial Contribution Allowed
Above $153,000: No Contribution Allowed

Traditional IRA Limits [b] 2023, Single
Under $73,000: Full Deduction Allowed
Between $73,000 and $83,000: Partial Deduction Allowed
Above $83,000: No Deduction Allowed

[b] The limits in this table apply if you are covered by a retirement plan such as a 401(k) at work. If you're not, the full deduction is allowed.

If your income level is in one of the highlighted boxes above, a Backdoor Roth IRA is probably a good idea.

IRA Eligibility Tool

Confused about your eligibility to contribute and deduct? This tool will help you determine your options.

The Pro Rata Rule And Non-Roth IRA Balances

The Backdoor Roth IRA gets complicated if you have existing non-Roth IRA accounts (i.e., Traditional, SEP, or SIMPLE IRAs). When you do a conversion to Roth, the IRS won't let you determine which of your non-Roth IRA account balances you convert. The conversion must be done "pro rata."

If the current value of your non-Roth IRA accounts is greater than the total of your nondeductible contributions, you will likely owe taxes on the conversion. In other words, if you have made tax deductible contributions to your Traditional IRA or rolled a 401(k) from a previous employer into your Traditional IRA, the conversion to a Roth will likely be a taxable event. Consider the following example:

- You have $100,000 in your Traditional IRA, which consists of previously made deductible (i.e., pre-tax) contributions and a rollover from a prior 401(k).
- You attempt a Backdoor Roth, making a $6,500 nondeductible contribution to your Traditional IRA and immediately rolling $6,500 over to a Roth IRA.
- On a "pro rata" basis, 94% of this conversion amount is taxable, because 94% of your Traditional IRA ($100,000 / $106,500) consisted of pretax contributions. In other words, you'll report $6,103 of income related to this conversion.

How To “Fix” Pro Rata Rule Issues

If you want to do a Backdoor Roth but have a large existing balance in your Traditional IRA, you have two real options.

- Convert your entire Traditional IRA to Roth now. This will almost certainly be a taxable event, but it may be a savvy move if your tax rates today are higher than you expect them to be in retirement. Make sure you understand the tradeoffs associated with this option (i.e., paying taxes upon conversion today in order to avoid taxes on withdrawal later). The IRA Conversion Tool can help you understand the different scenarios.
- Another option, which is more of a nontaxable workaround, is to roll your Traditional IRA into a 401(k). If your 401(k) accepts contributions from an IRA (not all of them do), this should be a nontaxable event. Once you've eliminated your Traditional IRA balances, a Backdoor Roth becomes much easier.

How A Backdoor Roth Creates Tax Free Wealth

The Roth IRA is an extremely tax efficient vehicle, for two simple reasons:

1. **Money Grows Tax Free.** Assets in a Roth IRA don't incur taxes on dividends or capital gains. If you hold assets in a taxable brokerage account, you will incur taxes whenever you receive dividends or realize a capital gain.
2. **Withdrawals Are Tax Free.** When you begin to withdraw money from your Roth IRA, you won't owe any taxes. If you use a taxable account to fund expenses in retirement, you may incur significant capital gains liabilities when you sell appreciated assets.

The Backdoor Roth is a powerful tool because it allows investors to shift money to an account (the Roth IRA) with more favorable tax treatment than the alternatives.

High earners typically have two alternatives to a Backdoor Roth:

1. **Leave It In A Taxable Account.** The worst option from a tax perspective; there is no deduction today, no tax free growth, and no tax free withdrawals.
2. **Nondeductible Contributions To A Traditional IRA.** This is slightly better -- at least the money grows tax free -- but still suboptimal since any gains will be taxed on withdrawal.

The table on the following page compares the tax advantages of a Backdoor Roth IRA relative to a "regular" Roth IRA and the Traditional IRA options:

	Backdoor Roth	Roth IRA	Traditional IRA [c]	Traditional IRA [d]	Taxable Account
Tax Deductible Contributions	❌	❌	✅	❌	❌
Tax Free Growth	✅	✅	✅	✅	❌
Tax Free Withdrawals	✅	✅	❌	❌	❌
Available to High Earners	✅	❌	❌	✅	✅
[c] This reflects deductible contributions to a Traditional IRA. [d] This reflects nondeductible contributions to a Traditional IRA. Withdrawals of nondeductible contributions are not taxed, but growth is.					

Example: Comparing IRA Scenarios

Consider the following scenario for a high earner:

- Able to make the maximum $6,500 contribution to an IRA.
- Current marginal tax rate (state and federal) is 35%.
- Expects annual returns of 8.0% in tax-sheltered accounts such as an IRA.
- Expects after-tax annual returns of 6.4% in taxable accounts.
- 25 year time horizon.
- Expects a marginal tax rate (state and federal) of 25% in retirement

Using these assumptions, the expected future after-tax value of the contribution in different scenarios would be:

	Backdoor Roth	Roth IRA	Traditional IRA [c]	Traditional IRA [d]	Taxable Account
Future Value	**$44,515**	Not Eligible	Not Eligible	**$35,011**	**$30,652**

[c] This reflects deductible contributions to a Traditional IRA.
[d] This reflects nondeductible contributions to a Traditional IRA. Withdrawals of nondeductible contributions are not taxed, but growth is.

Compared to investing in a taxable account, a Backdoor Roth could **create $13,863 of tax free wealth** for an individual or $27,726 for a couple each year.

Compared to making a nondeductible contribution to a Traditional IRA, a Backdoor Roth could **create $9,504 of tax free wealth** for an individual or $19,008 for a couple each year.

And, remember, you are currently allowed to do a Backdoor Roth every year.

IRA Scenario Tool

Want to customize these assumptions and see the complete methodology? This tool will help you determine your options.

Common Backdoor Roth IRA Mistakes

The Backdoor Roth IRA is pretty straightforward, but there are still several mistakes that investors can make:

1. **Triggering the Pro Rata Rule.** You can't pick and choose which parts of your non-Roth IRA you convert. If you make a conversion, including a Backdoor Roth, your tax consequences are based on the sum of your non-Roth IRA account holdings.
2. **Late Contributions or Conversions.** A Backdoor Roth IRA is cleanest when you make the contributions and the conversion in the calendar year. Technically, contributions to an IRA can be made until April 15 of the following year, but the nuances of Form 8606 make this timing a little complicated.
3. **Improper Allocations.** The Backdoor Roth IRA is cleanest when you delay allocating funds to anything besides cash until they are settled in the Roth IRA account. In other words, you shouldn't allocate your funds to stocks or bonds while they are sitting in your Traditional IRA. This can cause minor tax consequences, as well as complexities.
4. **Bad Assumptions.** The calculators included on this page include numerous assumptions about future returns and tax rates. If you're in the "simplified" case where you have no non-Roth IRA accounts, then a Backdoor Roth is a "no brainer." But if you will be incurring a tax liability with your conversion, the value of that conversion can change if your assumptions are bad (to see this illustrated, change the expected returns and future tax rates in the calculator above).

Other Backdoor Roth FAQs

Q: What Are The Costs Associated With A Backdoor Roth IRA?

A: There are no explicit costs associated with a Backdoor Roth IRA. You will be required to file a Form 8606 for each Backdoor Roth IRA contribution (or pay your CPA to complete it). That form is fairly straightforward. The next section includes an example of a Form 8606 for a Backdoor Roth IRA contribution with no complicating factors.

Q: Is There Gray Area With A Backdoor Roth IRA?

A: As of 2023, the Backdoor Roth IRA is not a particularly risky or aggressive tax savings move. It is very widely used by HNW investors, and is clearly permissible under current tax laws.

Congress has explicitly stated as much [Link]

Q: Could The Backdoor Roth IRA Benefit Disappear?

A: Yes.

It's possible that the benefit associated with the Backdoor Roth IRA could be impacted in several ways:

Income Limits Return: Prior to 2010, Roth IRA conversions were only allowed for individuals and couples whose MAGI was under a certain level. It's possible that this restriction returns in the future.

Other Exclusion: It's also possible that Roth IRA conversions are excluded for all income brackets. Democrats have previously included elimination of this tactic in proposals that ultimately were not passed. [Link]

Changes to Roth IRA: It's possible that Roth IRA withdrawals become taxable in the future, either for all investors or for those that meet certain income or wealth criteria. This seems unlikely because of the complexity it would create. But it's important to remember that your elected representatives hate you, spend like drunken sailors, and will go to great lengths to get more of your money.

Q: What Is the Maximum Amount Of A Backdoor Roth?

A: You're limited to the allowable limits for total IRA contributions set by the IRS. For 2023, that's $6,500 if you're under 50. If you're over 50, your limit is $7,500. These amounts change each year.

Additional Backdoor Roth IRA Resources

- Sample Form 8606
- IRA Eligibility Tool
- Traditional-To-Roth IRA Conversion Tool
- IRA Scenario Tool

Next Steps

If you're interested in alternative investments, make sure to check out the schedule of upcoming WealthChannel Events.

These events are tailor-made for investors who are interested in private equity, private credit, and real estate investments.

And don't forget to subscribe to the WealthChannel YouTube channel, updated several times per week with new content that can help you grow your wealth.