Backdoor Loophole

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Maybe this financial planning strategy is a loophole, and maybe it should be closed based on current tax policy. But the recent tax act, and several previous ones, failed to prevent people from making so-called 'backdoor' Roth IRA contributions.

The strategy is a workaround, around the fact that the IRS says that individuals with more than $153,000 in adjusted gross income, or couples earning over $228,000, are not permitted to contribute to a Roth IRA. Why would they want to? Unlike a traditional IRA, contributions to a Roth are not excluded from taxable income. (AKA after-tax contributions.) But the money contributed to a Roth, and all of the appreciation of its investments, can be taken out tax-free upon retirement. If you think taxes are going up, or you want more control over your taxable income during your retirement years, then a Roth account can be a handy part of your overall retirement assets.

So how does this 'backdoor' strategy work? Somebody whose income is above those thresholds can still contribute to a Roth account, under current rules (which have been threatened over and over again but are still perfectly legal) by first making a (nondeductible) contribution to a traditional IRA account. There are no income limits to who can make this contribution, which is limited to $6,500 a year (or, if your taxable income is lower, then your taxable income), with a $1,000 additional legal contribution for people 50 or older by the end of 2023.

Then you (or your advisor) would contact your IRA administrator to convert that contribution to a Roth IRA. That converts the contribution from tax-deductible to post-tax dollars, but it gets the money into an account that will never be taxed again.

The conversion can be a rollover from your traditional IRA into the Roth IRA, but a better strategy is a trustee-to-trustee transfer, where the traditional IRA provider would send the money directly to the Roth IRA provider (often the same entity).

Some individuals may benefit from a so-called 'mega backdoor' Roth contribution, which would generate higher contributions to the Roth account. This supersized version of the backdoor Roth works for individuals who have a 401(k) plan at work; an individual could put up to $43,500 of after-tax dollars into their plan, and up to $22,500 in deductible contributions, and then roll that money right back out into a Roth IRA or Roth 401(k).

This process can be complicated, so it helps to have a professional involved, and not all 401(k) plans permit the strategy. The plan has to permit in-service distributions while you're still working at the company, or let you move money from the after-tax portion of your plan into a Roth 401(k) plan administered by the company. Additionally, not all 401(k) plans allow after-tax contributions.

For at least the past three years, there have been proposals in Congress to terminate these 'backdoor' strategies, and it's logical to imagine that our elected representatives will eventually close this 'loophole,' but in the meantime feel free to enjoy the benefits of it while you can.

Sources:

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https://www.nerdwallet.com/article/investing/mega-backdoor-roths-work

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