



# ARE YOU USING THE TAX CODE TO YOUR ADVANTAGE?

## The Tax Strategy Many Business owners Never Discover

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## WHAT IS A "BACKDOOR ROTH IRA"?

An IRA, or Individual Retirement Account, allows for annual tax deductible contributions up to certain limits. That limit is \$7,500 (2026) and, if age 50 or older, an additional \$1,100 catch up contribution, bringing the total to \$8,600.<sup>1</sup> There are however, limits on deductible IRA contributions if one is a member of an employer sponsored retirement plan (401(k), SEP, SIMPLE, Cash Balance plan, etc.) and has Modified Adjusted Gross Income (MAGI) in excess of \$149,000 married filing jointly or \$91,000 single or head of household.<sup>2</sup>

If one's MAGI prevents deductible IRA contributions, there is the option of the non-deductible IRA.<sup>3</sup> Here is where the Backdoor Roth IRA concept begins.

A "Backdoor Roth IRA" is a strategy for high-income earners to contribute to Roth IRAs indirectly, bypassing the income limitations that prevent direct contributions. It involves making non-deductible contributions to a traditional IRA, and then converting those funds to a Roth IRA. This permits one to take advantage of the tax-free growth and income tax-free withdrawals of Roth IRAs, even when one's income exceeds the direct contribution limits.

## Here's how the Backdoor Roth IRA works:

- **Open an IRA account and Make a Non-Deductible Traditional IRA Contribution:**

Individuals make a contribution to a traditional IRA, understanding that the contribution won't be tax-deductible.

- **Convert the non-deductible Traditional IRA to Roth IRA:**

The funds in the non-deductible Traditional IRA are then converted to a Roth IRA. There is no taxable event as the IRA account was funded with after-tax dollars.

- **Tax Implications:**

While there are no income limits on Roth conversions, the conversion can trigger a tax liability on the earnings within the traditional IRA. In other words, from the time of the contribution to the Traditional non-deductible IRA and the time the Traditional non-deductible IRA is converted to the Roth IRA, any earnings on the account will be taxable at the time of conversion. That's a good reason to create and fund the account one day and convert the account the following day!

- **Advantages:**

This strategy allows high income earners to contribute to a Roth IRA and enjoy tax-free growth and tax-free future withdrawals. And, in many jurisdictions, IRA accounts are protected from the claim of judgment creditors! <sup>4</sup>

## Important Considerations

- **Taxable Conversion:**

The conversion from a traditional IRA to a Roth IRA is a taxable event, meaning you'll owe taxes on the amount converted.

When converting a non-deductible IRA to a Roth IRA, only the earnings on the non-deductible IRA account are taxable as income.

Nonetheless, many have other existing IRA accounts which may be converted to Roth status. These accounts, when converted to Roth status, will create a taxable event.

- **Five-Year Rule:**

To avoid penalties, you generally need to wait at least five years from the conversion date before making tax-free withdrawals.<sup>5</sup>

- **Mega Backdoor Roth**

Some 401(k) plans offer a similar strategy called a "Mega Backdoor Roth," allowing for larger after-tax contributions that can be converted to Roth 401(k)s.

## The Pro-Rata Rule

The **pro-rata rule** is an IRS requirement that determines the taxable portion of a Roth IRA conversion<sup>6</sup>.

It's not as easy as only converting your after-tax IRA account for a tax-free Roth conversion, since the IRS treats all your non-Roth IRAs as a single combined account and taxes the conversion proportionately based on that total balance.

### Here's how the Calculation Works

The rule uses a simple formula to determine the non-taxable percentage of your conversion:

- 1. Total After-Tax Basis:** Sum up all non-deductible contributions across all your Traditional, SEP, and SIMPLE IRAs.
- 2. Total IRA Value:** Sum up the total value of all those same accounts as of December 31st of the conversion year.
- 3. Non-Taxable Percentage:** Divide your after-tax basis by the total value.
- 4. Taxable Amount:** Multiply the amount you convert by the non-taxable percentage; the remaining balance is taxed as ordinary income.

### Example:

- You have \$93,000 in a pre-tax rollover IRA and make a \$7,000 after-tax contribution to a new Traditional IRA to do a "Backdoor" Roth conversion.
- Total IRA balance = \$100,000
- After-tax portion = 7% ( $\$7,000 \div \$100,000$ )
- If you convert the \$7,000 after-tax contribution you just made to the new Traditional IRA account, only 7% (\$490) is tax-free. You will owe income tax on the other 93% (\$6,510).

## Key Accounts Included

The IRS "aggregates" (combines) the following accounts for this rule:

- Traditional IRAs
- Rollover IRAs
- SEP IRAs
- SIMPLE IRAs

**Excluded Accounts:** The rule does not include employer-sponsored plans like 401(k)s, 403(b)s, or 457(b)s, nor does it include your spouse's IRAs.

## Avoiding the Pro-Rata Rule

There are several common strategies to minimize or bypass this tax implication:

- **Reverse Rollover:** If your employer plan allows it, you can roll your pre-tax IRA balance into your 401(k). This leaves only after-tax dollars in your IRA, allowing for a tax-free Roth conversion.
- **Qualified Charitable Distributions (QCDs):** For those 70½ or older, QCDs are taken specifically from pre-tax dollars, which can "burn down" the taxable portion of your IRA balance over time.
- **Wait for Low-Income Years:** If you cannot avoid the rule, consider converting during a year when your other income is lower to stay in a lower tax bracket.

**Don't forget to file Form 8606**

**Form:** <https://www.irs.gov/pub/irs-pdf/f8606.pdf>

**Instructions:** <https://www.irs.gov/pub/irs-pdf/i8606.pdf>

<sup>1</sup><https://www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-ira-contribution-limits>

<sup>2</sup><https://www.irs.gov/retirement-plans/plan-participant-employee/2024-ira-contribution-and-deduction-limits-effect-of-modified-agi-on-deductible-contributions-if-you-are-covered-by-a-retirement-plan-at-work>

<sup>3</sup><https://www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-ira-contribution-limits#:~:text=You%20can%20contribute,a%20certain%20level.>

<sup>4</sup><https://www.experian.com/blogs/ask-experian/are-retirement-accounts-protected-from-lawsuits/>

<sup>5</sup>[https://www.irs.gov/publications/p590b#en\\_US\\_2024\\_publink100089627:~:text=A%20qualified%20distribution%20is,a%20%2410%2C000%20lifetime%20limit\).](https://www.irs.gov/publications/p590b#en_US_2024_publink100089627:~:text=A%20qualified%20distribution%20is,a%20%2410%2C000%20lifetime%20limit).)

<sup>6</sup><https://www.irs.gov/retirement-plans/rollovers-of-after-tax-contributions-in-retirement-plans>

**IF YOU'D LIKE ME TO WALK YOU THROUGH A SPECIFIC  
CALCULATION BASED ON YOUR CURRENT SITUATION...**

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