Back-door Roth IRA Conversions

Monday, November 13, 2023

Take-Away: As 2023 comes to a close, some individuals with earnings will be considering a *backdoor* Roth IRA conversion. While the *backdoor* is a sound retirement planning strategy that is known, and accepted, by the IRS, it does come with several complications that need to be considered in advance of its implementation.

Background: The *backdoor* Roth IRA strategy is a valuable planning option for individuals whose high-income levels preclude them from making regular contributions to a Roth IRA. While there are income phaseouts that apply to contributions made to a Roth IRA, there are no such limitations on contributions made to a traditional IRA (since 2010.) The Roth income phaseouts are $146,000 to $161,000 for a single individual next year and $230,000 to $240,000 for a married couple starting next year. Admittedly, the amount of 'work' that goes into a *backdoor* Roth IRA conversion may not seem worth it if the maximum amount that can be contributed to the Roth IRA is $6,500. [Note, the maximum amount of an IRA contribution will be increased to $7,000 starting in 2024, with a 'catch-up' contribution amount of an additional $1,000 if the IRA owner is over the age of 50.]

> Think Company Plan, First: It is important to remember, too, that an individual who is interested in making a Roth contribution should first consider a Roth contribution to their employer-sponsored qualified plan, since qualified plans do not have earned- income limits that Roth IRAs have.

Backdoor Process: The *backdoor* strategy consists of a two-step process that involves: (i) a contribution (either deductible or nondeductible) made to a traditional IRA; the IRA contribution however is made with after-tax dollars; followed by (ii) the conversion of the traditional IRA to a Roth IRA. But that oversimplifies the many reporting requirements for a non-deductible IRA

(through filing Form 8606) and several IRS rules that deal with timing and accounting that convert a deceptively simple retirement contribution strategy (on its face) into the potential of lifetime extra paperwork by the Roth owner if that paperwork is completed incorrectly. And as we all know from experience and missives, if the individual has existing IRA dollars and/or if they plan to rollover funds from a qualified plan account at any time during the plan year, the *backdoor* Roth conversion strategy can become even more complicated. Consider all the following-

> Timing: The IRS has no specific rules on how much time must elapse between the non-deductible IRA contribution and the following Roth IRA conversion. As a general 'rule of thumb', more advisors recommend having these transactions appear on at least two different monthly statements, i.e., separate months, whenever possible so that in the event of an IRS audit, the auditors can more clearly see the steps that were taken by the account owner. By the same token, waiting too long between the contribution and the follow-up conversion can create issues as well, since any earnings that accrue to the traditional IRA before the Roth conversion, are taxable.
>
> Form 8606: If an individual has made an after-tax contribution to an IRA, e.g. maybe in the middle of the phaseout range, and instead of reversing the excess contribution they simple left the after-tax contribution in the traditional IRA as a non-deductible contribution, that IRA owner technically must file Form 8606 continually for any year there is a distribution from their IRA to properly calculate and report the *pro rata* portion of the distribution from the IRA that is tax-free.
>
> Form 1040: The Form 8606 is filed with the individual's Form 1040. Parts 1 and 2 of the 1040 will need to be completed, with the amount of the contribution appearing on multiple lines of the return, but it will ultimately end with the full contribution and conversion being reported as non-taxable in Part 1 on line 13 and with line 18 in Part 2 which asks for the taxable amount, being blank. The conversion amount will be reported as a

‘distribution’ on line 4a of Form 1040 (while being left out of line 4b because it is a non-taxable conversion of after-tax dollars.)

Aggregation Rule: This rule requires that when determining the tax consequences of an IRA distribution (which includes a Roth conversion) the value of all IRA accounts will be aggregated together for the purpose of any tax calculations, which can make the conversion process particularly messy. Specifically, this rule stipulates that when determining the tax consequences of an IRA distribution, including a Roth conversion, and the early withdrawal penalty [IRC 72(t)(1)] the value of all owned IRA accounts will be aggregated together for all tax calculations. [IRC 408(d)(2).] This *aggregation* rule thus means that before a conversion is made, the IRA owner must know about every IRA dollar, in each of his/her IRAs, and review all prior income tax returns, looking for a Form 8606, and to confirm that there will not be any rollovers during the remainder of the current year. Unfortunately a common mistake that is made is for an individual to open a separate IRA account with the intention of ‘holding’ the tax-free *basis* apart from other taxable IRA funds, or assuming that a *backdoor* Roth conversion can be completed mid-year before they retire in the autumn and then *rollover* over tax-deferred funds from their 401(k) plan into an IRA well after the mid-year *backdoor* conversion has been completed.

The *Pro Rata Rule, or Cream-in-the-Coffee* Rule: This is when things can get really complicated. This *pro rata* rule is described in IRC 72(e)(8). We’ve covered this rule in the past. It is informally called the *cream-in-the-coffee* rule. This descriptor comes from the analogy that once a person pours cream into their coffee, every sip is some portion of cream and coffee. Similarly, once non-deductible contributions are mixed into an aggregation of IRAs, every distribution (or conversion) is some portion of non-deductible and some taxable. The ‘cream’ never separates itself from the coffee, and thus the IRA owner will be left with taking and reporting *pro rata* distributions for evermore, or at least until such point as the after-tax contributions, i.e., *basis,* is effectively zeroed out of all IRA

accounts. In addition, if the IRA owner has tax-free *basis* in his/her traditional IRA, i.e., after-tax contributions, options to remove the taxable gain portion (and thus become eligible for a 'clean' *backdoor* Roth IRA) include converting the balance to a Roth (which could be done over multiple years) or rolling the pre-tax contribution funds into a qualified plan or a *solo* 401(k) plan. However, moving the after-tax contribution to a SIMPLE or SEP IRA will not work as they are included, or aggregated, with the traditional IRAs for purposes of implementing the *pro rata* rule.

Example: Archie made a $6,500 *backdoor* Roth IRA conversion in late 2023. His financial advisor told him this IRA would be tax-free. However, the advisor later finds out that on Archie's tax return and the accompanying Form 8606, that Archie had $100,000 of pre-tax money in a traditional IRA. Now, because the $100,000 of pre-tax and the $6,5000 of after-tax balances, the combined total account value reported on Line 6 of Form 8606 will be $106,500. Therefore, every future distribution from Archie's Roth IRA will be 93.9% taxable and 6.1% tax-free [$100,000 divided by $106,500 = 93.9%.] So that instead of Archie's $6,500 being converted wholly tax-free as his advisor had originally thought would be the case, what ended up was that only $397 was tax-free and the remaining $6,103 was taxable [$6,500 divided by 6.1% = $397.] Consequently, instead of reporting $0 as the taxable amount for IRA distributions as originally intended, Archie now needs to report $6,103 as taxable income on his Form 1040.

Separating the '*Cream from the Coffee:'* The simplest approach to dealing with the *pro rata* rule is for the IRA owner to withdraw and/or convert 100% of his/her IRA balances. But this might not be possible if the IRA balances (as aggregated) exceeded $2.0 million, where a conversion in one year would result in income tax-folly. One option, if possible if the IRA owner also participates in an employer sponsor-plan, is for the IRA owner to roll the pre-tax funds into their company qualified plan, leaving behind only the after-tax funds in the IRA, which could then be converted into a Roth IRA, and giving them an IRA balance of $0.00. Qualified plans cannot

accept after-tax contributions to a traditional IRA in a *rollup.* Therefore, moving money in and out of the employer-sponsored qualified plan, and timing the transfers correctly, and keeping good accounting records, might accomplish the intended *separation* of the *cream from the coffee.* Or a *rollup* into a *solo 401(k)* plan might work to accomplish the intended separation.

5-Step Checklist: When considering a *backdoor* Roth IRA conversion, several questions need to be asked:

1. Is a *backdoor* Roth contribution appropriate for the individual? This includes accounting for all IRA balances including those in SIMPLE and SEP IRAs and determining if there have been any other *rollovers* within the last 365 days, or if any of the existing IRAs have after-tax *basis.* If there is no 'clean' situation in anticipation of the *backdoor* Roth IRA conversion, is there a strategy to separate the *cream* from the *coffee?*

2. Was the traditional IRA contribution(s) done correctly? Was it made in the current year or a prior year? Can there be a catch-up contribution? Does the individual's account know if non-deductible contributions were made in the past?

3. Was the conversion distribution from the traditional IRA reported correctly? This includes ensuring that the Form 1099-R that is issued for the distribution will be marked by the custodian as 'taxable amount not determined' and will likely include the full reported amount as a 'taxable distribution.' In short, there needs to be communication that Form 1099-R is not misleading. The conversion will be correctly reported on the Form 1040.

4. Was the transfer to the Roth IRA reported as a Roth conversion? This will need to be reflected on both Form 1040 and Form 8606. Form 8606 is important to the paper trail if questions later arise about the conversion and contributions made into the Roth IRA, especially if the account owner

later needs to take out Roth conversion principal prior to age 59 ½ and needs to document that the 5-year rule on Roth conversions principal can be satisfied.

5. Was the individual's tax return filed correctly?

Conclusion: The *backdoor* Roth IRA conversion is a great retirement planning strategy. Starting next year up to $8,000 might be eligible for a *backdoor* Roth conversion. The challenge though is in implementing the strategy without mistakes, in light of the complex aggregation and *pro rata* rules, and the detailed reporting that is required, all of which requires an incredibly high attention to details that the individual may not want to be responsible for when it comes to making the decision to convert.