Backdoor Roth IRA Refresher

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Take-Away: As an individual's income continues to rise, the ability to make a Roth IRA contribution diminishes. Thus enters the 'backdoor' traditional IRA conversion to a Roth IRA strategy to enable high-earners the ability to contribute to a Roth IRA.

Background: Not everyone can contribute to a Roth IRA. Congress has imposed income limits for Roth IRA contributions. The Roth IRA income contribution thresholds for 2024 are $230,000 - $240,000 for married individuals filing jointly, and $146,000 - $161,000 for single individuals. For those individuals who have income above these limits, they are forbidden from contributing funds directly to a Roth IRA. If contributions are made by those with income above these limits, those contributions will be classified as *excess contributions* resulting in an excise tax. A 'backdoor' Roth conversion is the solution for these high-earning individuals.

Backdoor Roth IRA Simplified: The backdoor Roth IRA strategy is when the individual makes non-deductible contributions to a traditional IRA. That IRA is then converted to a Roth IRA, thus circumventing the income limitations. It is important to remember that there are no income restrictions on a Roth conversion. After earlier doubts, a backdoor Roth conversion was 'approved' by the IRS, meaning that a backdoor Roth conversion will not be challenged by it as a 'step-transaction.' That is the simple part of a backdoor Roth conversion. However, there are plenty of other 'rules' that make such a backdoor conversion not so simple.

Warning- the *Pro Rata* Rule: The *pro rata* rule requires that when an IRA contains both nondeductible (after-tax) and deductible (pre-tax) funds, each dollar withdrawn, or converted, from the IRA must contain a percentage of tax-free and taxable funds. This ratio is based on the percentage of after-tax dollars in *all* the IRA owner's traditional, SEP and SIMPLE IRAs. The IRA owner cannot target and convert just the after-tax contributions. [Note, though, that funds held in a qualified plan, e.g., a 401(k) account, are not counted in the *pro rata* formula or ratio.]

> Tax Consequences: If the IRA owner has after-tax dollars in his/her IRA, or basis, moving those dollars from the traditional IRA to the Roth IRA may be painful. The entire IRA could be converted, but that could cause a large income tax liability for the conversion of the pre-tax dollars held in the traditional IRA. It is the IRA owner's responsibility to track any *basis* in his/her IRA.

> Example: Ida owns only one IRA which has a balance of $100,000. Ida's IRA includes $80,000 of pre-tax contributions and $20,000 of after-tax contributions. This results in a 4:1 ratio between pre- and after- tax dollars. Consequently, any conversion that Ida does will be 80% taxable. Ida cannot 'cherry-pick' only the $20,000 for her Roth IRA conversion. Ida may not be able to afford the income taxation of the $80,000 in the anticipated Roth conversion.

Isolating Basis: In some situations, basis in the IRA, i.e., the after-tax contributions, can be isolated. The pre-tax IRA contributions could be rolled over into a 401(k), since after-tax and Roth contributions cannot be rolled into a qualified plan from an IRA. But that is only if the IRA owner also has access to a 401(k) plan to make contributions.

> Example: Same facts as in the prior example. If Ida participates in her employer's 401(k) plan that allows IRA rollovers, Ida could roll-up the $80,000 of her pre-tax dollars from her IRA to her employer's 401(k) account, leaving the $20,000 after-tax contributed dollars available for the anticipated Roth IRA conversion.

> HSA: Yet another way to isolate basis in the traditional IRA, but only a relatively small amount, is to make a distribution to a qualified health saving account (HSA), since only pre-tax IRA funds can be used for these distributions, which are statutory exceptions to the *pro rata* rule.

QCD: Or, following the example, if Ida is over the age 70 ½ and charitably inclined, she could make a qualified charitable distribution (QCD) from her IRA of $80,000, since it too is a statutory exception to the *pro rata* rule, again leaving the $20,000 of the after-tax contribution in Ida's traditional IRA that is now available for a Roth IRA conversion.

Tax Reporting: Moreover, there are several tax forms that must be filed associated with a backdoor Roth conversion.

Form 8606: When a non-deductible contribution is made to an IRA, the IRA owner must declare that there are after-tax dollars in the IRA. This declaration is on Form 8606. Failure to file this Form could result in double taxation, since the IRS would have no knowledge of any non-deductible contribution. When tax reporting occurs, another section of the three-part Form 8606 is used to document the *pro rata* math and how much of the Roth conversion is taxable.

Form 1099-R: When funds leave a traditional IRA by a conversion, a Form 1099-R is created the following year. If the IRA owner is under age 59 ½, the Form 1099-R will report the conversion in box 7, using Code 2, 'early distribution, exception applies (under age 59 ½).' If the IRA owner is age 59 ½ or older than Code 7 ('Normal distribution' is used. If any income taxes were withheld on the conversion, that amount will be reported on the Form 1099-R in box 4, 'Federal income tax withheld.' Note that if the IRA owner is under the age 59 ½ has taxes withheld from his/her IRA, those taxes do not get converted and they are considered to be an early withdrawal by the IRA owner. If no other exception applies, the income taxes withheld by the younger IRA owner will be subject to the 10% early distribution excise tax. For this reason, with a Roth conversion, the custodian will normally recommend for the IRA owner who is under the age 59 ½ to have the income taxes due on the Roth IRA conversion paid from a source other than the IRA itself.

Form 5498: A backdoor Roth IRA will also require the use of Form 5498 which documents the conversion. The conversion amount is reported in box 3. In addition, the IRA custodian will use Form 5498 to report the year for which a contribution is made. This Form is given to both the IRS and to the IRA owner for 'informational purposes only.' The Form does not have to be filed with the IRA owner's income tax return.

Crossing Tax Years: Some confusion can also arise when an IRA owner makes a prior year non-deductible IRA contribution in January of the next year, but then immediately converts that contribution to a Roth IRA. In this situation, a Form 8606 for the prior year's income tax return will be necessary to claim the 'basis' in the contribution. The Roth IRA conversion will generate a Form 1099-R and a Form 5498 (both issued in the following year) for that next year, and a second Form 8606 must be filed with the next year's tax return to document the *pro rata* math.

Example: Irene, age 40, is high-earner with reported income in 2023 that is well over the current earned income Roth contribution limitations. Irene expects to continue to earn income at high levels in the coming year. As such, Irene is not eligible to contribute directly to a Roth IRA. Instead, Irene is considering a backdoor Roth IRA conversion. In February 2024 Irene makes a $6,500 non-deductible contribution for 2023 and she makes a second $7,000 2024 non-deductible contribution to a traditional IRA. Irene then immediately converts the $13,500 in her traditional IRA to a Roth IRA. Irene has no other IRAs. Accordingly, this is a 'clean conversion' by Irene without the implication of the *pro rata* rule. The tax Forms that will be generated by Irene's actions include: (i) Form 8606 for 2023 to report her $6,500 non-deductible contribution, to be filed with Irene's 2023 Form 1040 tax return; (ii) Form 8606 for her 2024 reporting of her $7,000 non-deductible contribution and documenting the taxable amount ($0.00) of the conversion; (iii) Form 1099-R to show the distribution from her traditional IRA; and (iv)Form 5498 for 2024 that reports the subsequent conversion of the $13,500 to Irene's Roth IRA.

Conclusion: A backdoor Roth IRA conversion is an excellent strategy to permit a high-earning individual to contribute funds to a Roth IRA using after-tax contributions to a traditional IRA. That said, there are complications to implement the strategy if the *pro rata* rule must be navigated, and plenty of IRS Forms to be completed and timely filed.