Backdoor Roths, Retirement Account Basis, and the Pro-Rata Rule

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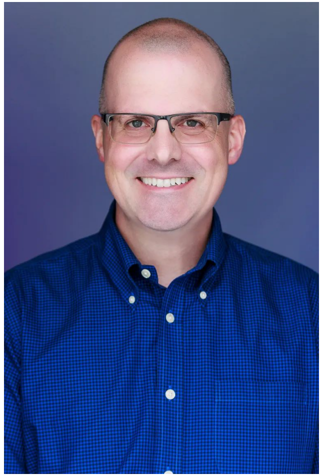

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IRA History

Important Dates

September 2, 1974: ERISA passes. Adds to the tax law:

Individual Retirement Accounts (starting in 1975). See page 131 of the ERISA PDF: https://www.govinfo.gov/content/pkg/STATUTE-88/pdf/STATUTE-88-Pg829.pdf

> **Annual contributions initially limited to $1,500 per person per year. Inflation adjusted in 2023 that is $8,458.08**

October 22, 1986: Tax Reform Act of 1986 passes. Adds to the tax law:

Nondeductible contributions to IRAs (starting in 1987). See section 1102 of TRA '86 (page 330 https://www.ucop.edu/research-policy-analysis-coordination/_files/Public%20Law%2099-514.pdf) If covered by a workplace plan, deduction for an IRA contribution phased out above certain income limits. See https://www.forbes.com/sites/kellyphillipserb/2011/06/27/deduct-this-history-of-the-ira-deduction/?sh=23475ee37e7d

> ***Nondeductible contributions to a traditional IRA create basis.***

Nondeductible IRA's Value

Were nondeductible IRAs a bad thing? Not really. Contribution limits were modest ($2K limit from ‘82 to ‘01). Many investors then and now wanted some allocation to bonds.

Why not put bonds/bond funds inside a traditional IRA to get (i) at least some creditor protection, and (ii) tax deferral for the interest income until the investor wanted the money (or to, back then, age 70 ½, and even then RMDs in one's 70s were modest). Further, any withdrawals of the interest income were partially shielded from income tax due to ratable recovery of basis.

Birth of the Roth IRA

In 1997 Congress established the Roth IRA (effective in 1998).

Congress imposed (i) an annual MAGI limitation on the ability to make a Roth IRA annual contribution and (ii) an annual $100K MAGI limitation on the ability to do a Roth conversion. See https://fitaxguy.com/the-magi-limitation-on-roth-ira-contributions/

Thus, for most individuals using the nondeductible IRA contribution strategy, the introduction of the Roth IRA was not consequential at the time.

Birth of the Backdoor Roth IRA

In 2006 Congress removed the $100K cap on the ability to do a Roth conversion starting in the year 2010.

See pages 21 and 22 of this PDF:
https://www.govinfo.gov/content/pkg/PLAW-109publ222/pdf/PLAW-109publ222.pdf

This opened up the Backdoor Roth IRA!

Backdoor Roth IRA Basics

Basics of the Backdoor Roth IRA

The Backdoor Roth IRA is a two-step transaction.

Step 1: Taxpayer contributes to a traditional, nondeductible IRA.

- This creates helpful IRA basis to *potentially* shield Step 2 from significant taxation.

Step 2: Relatively soon after Step 1, the taxpayer converts the <u>entire balance</u> in the traditional, nondeductible IRA to a Roth IRA.

For more information, please see https://fitaxguy.com/backdoor-roth-iras-for-beginners/

Backdoor Roth IRA: So What?

What does the taxpayer accomplish by implementing a Backdoor Roth IRA?

Generally speaking, the Backdoor Roth IRA houses funds that would have been held in a taxable brokerage account. Thus, by doing the Backdoor Roth IRA, we move (in a generally tax-free manner) wealth out of income taxation during the owner's lifetime/spouse's lifetime (and usually for 10 more years after death) and we've increased, to at least some degree, the creditor protection available with respect to those assets.

Backdoor Roth IRA: The Big Caveat

The Backdoor Roth IRA planning <u>does not work well</u> if the taxpayer has any material balance in traditional IRAs, SEP IRAs, and/or SIMPLE IRAs as of <u>December 31st</u> of any year he or she has done the Roth conversion step of a Backdoor Roth IRA and/or a Basis Isolation Backdoor Roth IRA (discussed later).

Backdoor Roth IRA: Example

Peggy, age 35, single, and covered by a workplace retirement plan, correctly anticipates having $220K of modified adjusted gross income ("MAGI") in 2023. She has no balances in traditional IRAs, SEP IRAs, and SIMPLE IRAs. On New Year's Day 2023 she logs into her accounts and makes a $6,500 nondeductible contribution to her traditional IRA. She invests the money in a money market account. This nondeductible contribution creates $6,500 of IRA basis.

On February 5, 2023, when the traditional IRA has a $6,503 balance, she converts the entire balance to a Roth IRA and invests the Roth IRA consistent with her own investment objectives. She ensures that on December 31, 2023, she has $0 balances in all traditional IRAs, SEP IRAs, and SIMPLE IRAs. Peggy pays income tax on the $3 of growth since $6,500 of the Roth conversion is shielded by IRA basis.

Imagine the sort of tax-free wealth Peggy could generate if she did this planning for 15, 20, or 25 years!

Peggy's Pro-Rata Rule Calculation

Item	Amount
(A) Basis	$6,500
(B) Roth Conversion	$6,503
(C) Year End Amounts in IRAs	$0
(D) B Plus C	$6,503
(E) Basis Percent Allocated to Conversion (B divided by D)	100.00%
(F) Basis Percent Allocated to Y/E IRA Balance (C divided by D)	0.00%
(G) Basis Recovered on Conversion (A times E)	$6,500
(H) Taxable Amount of Conversion (B minus G)	**$3**

Backdoor Roth IRA: Practical Considerations

I recommend that the investment in the traditional, nondeductible IRA be invested in a manner that reduces volatility. Growth between Steps 1 and 2 is taxed to the taxpayer as ordinary income (no 10% penalty, however).

Backdoor Roth IRA: Practical Considerations Continued

Timing of Step 2: This has been an area of debate.

- Michael Kitces Step Transaction Doctrine Concern
  - Potential annual 6% Roth IRA excess contribution penalty
  - Anecdotally, I believe the concern is not widely shared among practitioners. For example, Kitces' well respected colleague Jeffrey Levine disagrees.
- My Take on Step Transaction Concern Published in Tax Notes in 2019
  - Consider also Section 408(d)(2)(B)
- IRS informal comments and TCJA legislative history on this issue (not binding, but still informative)
- I consider the old Ed Slott tactic (wait till after of the end of the month of Step 1) to still be a best practice. Many practitioners reasonably have a different view and would not recommend waiting that long.

Backdoor Roth IRA: Advanced Topics

The Problem of the Pro-Rata Rule

Polly, age 35, single, and covered by a workplace retirement plan, correctly anticipates having $220K of modified adjusted gross income ("MAGI") in 2023. On New Year's Day 2023 she logs into her accounts and makes a $6,500 nondeductible contribution to her traditional IRA. She invests the money in a money market account. This nondeductible contribution creates $6,500 of IRA basis.

On February 5, 2023, when the traditional IRA has a $6,503 balance, she converts the entire balance to a Roth IRA and invests the Roth IRA consistent with her own investment objectives.

BUT . . . she does have an old rollover traditional IRA (from her former employer's 401(k) plan) worth $100,000 at year-end. Ruh roh!

Unlike Peggy, who paid tax on just $3, Polly must pay income tax on $6,106!

Under the Pro-Rata Rule, Polly must allocate the $6,500 in basis she created on New Year's Day between the converted amount and the amount remaining in her traditional IRA at year-end. Ouch!

The Pro-Rata Rule Rule

The Pro-Rata Rule functions to allocate IRA basis between (i) distributions and conversions during the year and (ii) year-end balances in all traditional IRAs, SEP IRAs, and SIMPLE IRAs.

Polly's Pro-Rata Rule Calculation

Item	Amount
(A) Basis	$6,500
(B) Roth Conversion	$6,503
(C) Year End Amounts in IRAs	$100,000
(D) B Plus C	$106,503
(E) Basis Percent Allocated to Conversion (B divided by D)	6.11%
(F) Basis Percent Allocated to Y/E IRA Balance (C divided by D)	93.89%
(G) Basis Recovered on Conversion (A times E)	$397
(H) Taxable Amount of Conversion (B minus G)	**$6,106**

Planning to Avoid Eliminate Pro-Rata Rule Problem

What could Polly do?

If Polly has a W-2 job with an employer that offers a qualified plan (401(k), etc.), she could transfer the old traditional IRA to that 401(k) to get “clean” for Pro-Rata Rule purposes. Then she could implement Backdoor Roth IRA planning. See https://fitaxguy.com/what-to-do-if-you-dont-qualify-for-a-backdoor-roth-ira/

Planning to Avoid Eliminate Pro-Rata Rule Problem Continued

Should Polly do "clean up" planning?

If Polly is close to retirement, and this will facilitate only one or two years of Backdoor Roth IRAs, it's likely not worth it.

Consider IRA size.

Consider investment options and fees inside the receiving qualified plan.

Note that workplace qualified plans are not legally required to accept IRA roll ins, or may be written to only accept certain roll ins (such as roll ins of old qualified plans – so called "conduit IRAs").

Quick Notes on Transfers

Anytime retirement accounts are transferred to another retirement account, direct trustee-to-trustee transfers are preferable. In a direct trustee-to-trustee transfer, the taxpayer never sees the cash or check.

If the taxpayer receives a check in his or her own name, they have 60 days to get the money into the new retirement plan or else they could face taxation and/or penalties and the inability to get the money back into a retirement account. This sort of transfer is a "60 day rollover."

Note that IRA-to-IRA 60 day rollovers are subject a "once-every-12-months" limit, which is another reason to favor direct trustee-to-trustee transfers.

The once-every-12-months limit does NOT apply to (i) ALL direct trustee-to-trustee transfers (including IRA-to-IRA), (ii), Roth conversions, (iii) IRA to qualified plan 60 day rollovers, (iv) qualified plan to IRA 60 day rollovers, and (v) qualified plan to qualified plan 60 day rollovers.

If a 60 day rollover is used for any transfer, usually it is important to ensure there is no income tax withholding.

What About a Solo 401(k)?

Is it possible to do Backdoor Roth IRA clean up using a Solo 401(k)? Yes. But it requires additional caution.

For example, consider the risk of IRS disqualification of a large employer 401(k) versus a Solo 401(k). From a purely strategic perspective, the IRS may be much less hesitant to disqualify a Solo 401(k) than a large employer's 401(k) considering the adverse follow on tax effects that could be suffered by thousands of employees of a large employer.

Basis Isolation Planning

Example: It is July 2023. You have a new client, age 47, with $300K plus of MAGI. New client has previously made $18,000 of nondeductible traditional IRA contributions (for 2020 through 2022) which have now grown into $25,000 in IRA 1. Separately new client has a $200K traditional IRA (a rollover from the previous employer, IRA 2). New client's current employer's 401(k) accepts IRA roll ins.

What could new client do?

Basis Isolation Planning Continued

Assuming new client is satisfied with the investment options and fees inside their employer 401(k), new client could proceed as follows:

Step 1: Direct trustee-to-trustee transfer of all of IRA 2 to employer 401(k) in July.

Step 2: Invest $18,000 and a little change in IRA 1 in a money market fund or cash. This is to ensure compliance with the tax rule Step 3 is required to satisfy. Hold remainder of IRA 1 in a separate mutual fund/ETF ("Fund A") in July.

Step 3: Transfer the entirety of IRA 1 Fund A to the employer 401(k) in a direct trustee-to-trustee transfer in July. Leave behind in IRA 1 the money market fund or cash that is at least equal to a little more than the basis ($18K).

- The "leave behind" is required by the Internal Revenue Code. IRA basis cannot be transferred to a qualified plan. By ensuring that the leave behind asset is worth at least the basis (and just a bit more), we ensure compliance with this rule. If the leave behind asset declined in value, Steps 1 and/or 3 could create a prohibited transfer of basis into the 401(k). Fortunately, this is a tax rule that turns out to be very taxpayer favorable from a planning perspective.

Step 4: Once Steps 1 through 3 are complete, convert the entirety of the leave behind asset (a bit over $18K) from IRA 1 to a Roth IRA. Only the "bit over $18K" and any additional growth should be taxable in 2023.

Basis Isolation Planning Continued

Step 5: Once Step 4 is complete, contribute $6,500 to a traditional, nondeductible IRA for 2023.

Step 6: In the month following the completion of Step 5, convert the entire balance in the traditional, nondeductible IRA to a Roth IRA. Any growth over $6,500 should be taxable.

Step 7: Ensure that as of December 31, 2023 there are no balances in any traditional IRA, SEP IRA, or SIMPLE IRA.

Step 8: File with the 2023 federal income tax return a Form 8606 reporting the pre-existing $18K of basis and Steps 4, 5, and 6. Only Steps 4 and 6 should create any taxable income (usually only minorly so, it should only be on the growth noted above). Note that for Steps 1 and 3, the IRA custodian should generate a Form 1099-R reporting the transfer, and the amounts should be reported on Form 1040, Line 4(a) (along with the gross amounts in Steps 4 and 6), but the amounts reported on the Steps 1 and 3 Forms 1099-R should be entirely nontaxable.

This is pretty good planning: In 2023, new client got almost $25K into a Roth IRA! A bit over $18K through what I refer to as a Basis Isolation Backdoor Roth IRA, and $6,500 through the conventional annual Backdoor Roth IRA.

New Client's Pro-Rata Rule Calculation

Item	Amount
(A) Basis	$24,500
(B) Roth Conversion	$24,520
(C) Year End Amounts in IRAs	$0
(D) B Plus C	$24,520
(E) Basis Percent Allocated to Conversion (B divided by D)	100.00%
(F) Basis Percent Allocated to Y/E IRA Balance (C divided by D)	0.00%
(G) Basis Recovered on Conversion (A times E)	$24,500
(H) Taxable Amount of Conversion (B minus G)	**$20**

Assume IRA 1 had $18,010 after Step 2 in a money market account. That holding earned $7 of interest immediate before Step 4. Further assume that the $6,500 in the nondeductible traditional IRA earned $3 of interest in between Steps 5 and 6.

Basis Isolation Backdoor Roth IRA

Remember, the Basis Isolation Backdoor Roth IRA is <u>not</u> an affirmative planning tactic. The annual Backdoor Roth IRA is an affirmative planning tactic.

Rather, the Basis Isolation Backdoor Roth IRA is a potentially valuable unwinding tactic (or clean-up tactic) which can unwind existing IRA basis from other amounts inside IRAs.

Split-Year Backdoor Roth IRAs

It's possible to implement (in whole or in part) a Backdoor Roth IRA for one year in the succeeding tax year. Key deadline is the April 15th deadline to make the nondeductible traditional IRA contribution for the prior year. See https://fitaxguy.com/split-year-backdoor-roth-iras/

Fixing Backdoor Roth IRAs

There's much confusion when it comes to tax reporting and Backdoor Roth IRAs. It is possible taxpayers have incorrectly reported previous Backdoor Roth IRAs, resulting in overpayments of tax. Amending tax returns can obtain income tax refunds. Consider statute of limitations (very generally 3 years for federal returns, but there is some nuance). See https://fitaxguy.com/fixing-backdoor-roth-iras/

Mega Backdoor Roth

Mega Backdoor Roth

Two Step Transaction

1) After-tax employee contribution to traditional 401(k) (which creates helpful basis), followed soon thereafter by either

2A) An in-plan conversion of the after-tax 401(k) to a Roth 401(k), or

2B) An in-service roll-out of the after-tax 401(k) to a Roth IRA.

Mega Backdoor Roth History

The IRS and Treasury opened the floodgates with Notice 2014-54. Prior to this notice, there was ambiguity about whether something like the Mega Backdoor Roth was possible.

To this day, many 401(k) plans do not offer the first step, so availability of the technique is limited.

Mega Backdoor Roth: So What?

What does the taxpayer accomplish by implementing a Mega Backdoor Roth?

Generally speaking, the Mega Backdoor Roth achieves the planning objectives the Backdoor Roth IRA achieves, only to a great degree. The Mega Backdoor Roth houses funds that would have been held in a taxable brokerage account. Thus, by doing the Mega Backdoor Roth, we move (in a generally tax-free manner) wealth out of income taxation during the owner's lifetime/spouse's lifetime (and usually for 10 more years after death) and we've increased, to at least some degree, the creditor protection available with respect to those assets.

Mega Backdoor Roth Limit

The main limit on the Mega Backdoor Roth is the Section 415(c) All Additions Limit ($66K for 2023, $73.5K for those age 50 and older). Any after-tax contributions have to be tested against all other contributions to the employer's qualified plans for the year to the employee to ensure there is sufficient runway to make the after-tax contribution.

Note that the 415(c) limit is per employer.

Mega Backdoor Roth Limit Example

Carl, age 46, works as Acme Industries and has a W-2 salary of $250K in 2023. He maxes out his employee deferrals to the 401(k) at $22,500. Further, Acme Industries matches 3% of salary contributed to the 401(k) dollar for dollar and offers plan participants both Steps 1 and 2A.

How much can Carl contribute to a Mega Backdoor Roth?

Mega Backdoor Roth Limit Example Continued

Item	Amount
(A) 2023 415(c) Limit	$66,000
(B) Employee Deferrals	$22,500
(C) Employer Match	$7,500
Total Possible After-Tax Contributions for Mega Backdoor Roth (A)-(B)-(C)	**$36,000**

What About the Pro-Rata Rule?

Qualified plans are not subject to the Pro-Rata Rule. Further, distributions from qualified plans are assessed plan by plan, while IRAs are aggregated to determine the taxation of any distribution or conversion.

Mega Backdoor Roth Multiple Employers

Since the main governor on the Mega Backdoor Roth is the 415(c) All Additions limit, and this limit is per employer, it is at least theoretically possible to do a Mega Backdoor Roth separately with two separate employers. See https://www.irahelp.com/slottreport/beneficiary-rmd-rules-and-401k-contribution-limits-today's-slott-report-mailbag

Solo 401(k)s and the Mega Backdoor Roth

Some Solo 401(k)s offer after-tax employee contributions. But consider:

- Lack of access to many pre-approved plans.
- Many Solopreneurs won't have much in the way of either or both limitation and cash flow to make after-tax contributions.
- Compare with Mega Backdoor Roth at large employers (lower employer contributions make Mega Backdoor Roth at large employer much more attractive).

Retirement Account Basis Transfers

IRA basis <u>CANNOT</u> be transferred to a traditional qualified retirement plan (401(k), etc.).

Traditional qualified retirement plan basis <u>CAN, BUT GENERALLY SHOULD NOT</u> be transferred to a traditional IRA. Why?

It should be transferred instead to a ROTH IRA under Notice 2014-54.

Lessons for 401(k) Roll Outs

There will be some employees who separate from service with after-tax traditional 401(k) balances. For those looking to transfer to an IRA or IRAs, consideration should be given to Notice 2014-54.

That after-tax 401(k) could become a Roth IRA!

Of course, this is only one of many factors to consider prior to moving a workplace retirement plan.

Back to the Future! Of the Backdoor Roth

The Future

In the short term (through the end of 2024), both the Backdoor Roth IRA and the Mega Backdoor Roth appear safe (in my opinion) with a divided Congress.

After that, there is risk that either or both could be repealed. The 2021 Build Back Better proposal proposed to eliminate both.

Backdoor Roth IRA is a loophole that compensates for a very bad rule (income limits on annual Roth IRA contributions, consider Canadian TFSA)

Mega Backdoor Roth is a loophole that is much more questionable. Only a relatively small cohort of Americans have any access to it.

- Legislative uncertainty significantly reduces the chances most pre-approved Solo 401(k) providers will offer the Mega Backdoor Roth anytime soon.