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# Mo Money Mo Problems: Backdoor Roth IRAs

Clients of all income levels should understand the importance and advantages of diversifying their retirement savings. Utilizing various assets to fund their retirement income gives them the flexibility to help manage their income (and taxes) during retirement. Of the various options for saving for retirement, Roth 401(k) plans, Roth IRAs, and life insurance allow clients to draw tax-free income during retirement. However, not all clients will have the opportunity to take advantage of each of these options.

Clients who opt not to make contributions to a Roth 401(k) (or who may not participate in an employer-sponsored plan that offers this option) or who do not otherwise plan to use life insurance for retirement income (perhaps to preserve the death benefit for other purposes, such as legacy needs), should consider making contributions to a Roth IRA. Given the income eligibility limits currently in place for contributing to a Roth IRA, many clients may not be eligible for Roth IRAs, at least not in the traditional sense. This article discusses a planning opportunity for these kinds of clients to consider, along with its problems.

## The Mechanics of a Backdoor Roth IRA

Roth IRAs provide many tax benefits, including income tax-free growth,[1] the avoidance of required minimum distributions,[2] and the ability to get one's contributions back income tax-free.[3]

Additionally, beneficiaries of inherited Roth IRAs receive qualified distributions on a tax-free basis.[4]

Furthermore, for those who have a net worth that exceeds the estate tax exemptions, converting to a Roth IRA can reduce the total amount of tax (both income and estate tax) that will go to the government.[5]

For those who exceed the modified adjusted gross income (MAGI)[6] thresholds, contributing directly into a Roth IRA is not an option (for example, in 2018 couples who file jointly cannot contribute to a Roth IRA if their MAGI exceeds $199,000).[7] You may have heard about a strategy to avoid this limitation whereby one contributes to a nondeductible IRA with the intent of later converting to a Roth IRA. This strategy is commonly known as a "Backdoor Roth IRA." While the strategy sounds simple, the IRS may view this transaction as abusive and it may result in a higher tax bill than anticipated.

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[1] Qualified distribution from a Roth IRA are not subject to income tax or a 10% penalty. I.R.C. § 408A(d); Treas. Reg. § 1.408A-6, Q&A5(a). A qualified distribution is one that is (1) made after the 5-year period beginning with the first taxable year for which the individual made any contribution to any Roth IRA and is (2) any one of the following: (A) made on or after the date on which the taxpayer turns age 59 ½; (B) made to a beneficiary on or after the death of the taxpayer; (C) Attributable to the taxpayer being disabled; or (D) A qualified first-time homebuyer distribution. I.R.C. § 408A(d)(2).

[2] I.R.C. § 408A(c)(5).

[3] Generally, Roth IRA contributions can be withdrawn tax and penalty free. I.R.C. § 408A(d)(4)(B)(ii)(I). Roth IRA conversions can be withdrawn to the extent of basis tax free, but a 10% penalty will apply if it's withdrawn within the five-taxable year period. *See*, I.R.C. § 408A(d)(3)(F).

[4] I.R.C. § 408A(d)(2).

[5] Different tools and calculators can show the overall tax reduction on converting to a Roth IRA for a particular client's facts and circumstances.

[6] MAGI is calculated using the taxpayers adjusted gross income ("AGI") found on the last line of Form 1040, U.S. Individual Income Tax Return (reported on line 37 on the 2016 edition), plus the following: traditional IRA deduction; student loan interest deduction; tuition and fees deduction; domestic production activities deduction; foreign earned income exclusion; foreign housing exclusion or deduction; exclusion for qualified bond interest; and exclusion of employer-provided adoption expenses. I.RC. § 219(g)(3)(A).

[7] For 2018, for taxpayers filing jointly the phase-out begins at MAGI of $189,000 and are fully phased out at $199,000. For single taxpayers, the MAGI phase-out begins at $120,000 and ends at $135,000. See I.R.C. § 408A(c)(3) and IRS Notice 2017-64.

## The Step Transaction Doctrine

The IRS may attack the Backdoor Roth strategy under the Step Transaction Doctrine. The Step Transaction Doctrine originates from court cases and is nebulous because it focuses on the intent of the taxpayer. The Step Transaction Doctrine collapses separate and distinct steps into a single, unified transaction for tax purposes.[8]

For the purposes of the Backdoor Roth IRA, there are two steps that by themselves would not create tax problems (i.e., Step 1: Contribute to a nondeductible IRA; Step 2: Convert nondeductible IRA to a Roth IRA). However, if these two transactions are viewed as a single, unified transaction, it appears as if the taxpayer directly contributed to a Roth IRA. If the taxpayer is above the contribution thresholds, he or she has now made a contribution that they were not allowed.[9]

So what factors would the IRS or a court look at when evaluating the Step Transaction Doctrine? Generally, they would look to the intent of the taxpayer – did the taxpayer intend to bypass the tax laws? Some factors the IRS or a court would weigh include whether the Roth IRA conversion created income tax from either earnings or pre-tax contributions and the time between the nondeductible contribution and Roth IRA conversion. As a general proposition, the IRS does not like this type of planning and views it as abusive. Previous presidential administrations proposed limiting the ability to use this technique by allowing only pre-tax amounts to be converted.[10]

## The IRA Aggregation Rule

The second issue is the IRA Aggregation Rule. When the tax code is applied to a Roth IRA conversion, it views the taxpayer as having only one IRA, even if the taxpayer has several IRA accounts.[11] This is often referred to as the IRA Aggregation Rule. In essence, the taxpayers cannot choose which accounts they wish to convert to a Roth IRA. When a taxpayer with multiple accounts (both deductible and nondeductible IRAs) converts to a Roth IRA, the conversion is prorated, using overall gain and basis from all IRAs. To illustrate, here is an example:

Emerson has two IRAs. Emerson's first IRA came from all deductible contributions and has a fair market value of $300,000. Emerson's second IRA was just opened with nondeductible contributions of $5,500 and has a fair market value of $5,500. Under these facts, the total fair market value of IRAs is $305,500, the total nondeductible contributions are $5,500, and the total conversion equals $5,500. The equation for calculating the amount of ordinary income on a Roth conversion equals:

Total conversion – [Total conversion * (nondeductible contributions/total fair market value of IRAs)].

$5,500- [$5,500 X ($5,500/$305,500)] = $5,401

If Emerson converts only the second IRA, she will recognize $5,401 of ordinary income, not zero. She will have a remaining basis in her nondeductible IRA of the same amount and will have used only $99 of her basis.

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[8] See *Gregory v. Helvering*, 293 U.S. 465 (1935); *Commissioner v. Clark*, 489 U.S. 726 (1989).

[9] If someone were to contribute to a plan when he or she were ineligible, this would yield a 6% penalty tax on any excess contribution to a Roth IRA. I.R.C. § 4973. IRS Form 5329, *Additional Tax on Qualified Plans (Including IRAs) and Other Tax Favored Accounts*, Part IV is where a taxpayer would report the excess contribution.

[10] General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals on page 172. [12] I.R.C. § 408(d)(2).

[11] I.R.C. § 408(d)(2).



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For some taxpayers, this may come as an unpleasant surprise when they file their income tax return on April 15th. Taxpayers with an existing IRA may find it cost prohibitive to take advantage of the Backdoor Roth strategy. In our example above, if Emerson did not have an existing IRA, she could have converted the $5,500 IRA to a Roth IRA with no income recognized.

Three important nuances to the IRA aggregation rule.

1. The IRA aggregation rule applies on an owner-by-owner basis. This means that a wife's IRAs are not aggregated together with her husband's IRAs, even if they file a joint tax return.
2. The IRA aggregation rule does not include qualified plans, such as a 401(k) or profit-sharing plans. However, the rule includes SIMPLE IRAs and SEP IRAs.
3. Inherited IRAs are not included in the IRA aggregation rule, as the owner of the IRA is the decedent, not the beneficiary.

The New Tax Law eliminated the ability to "undo" a conversion via a subsequent recharacterization for tax years beginning after December 31, 2017.[12] However, the law did not remove the MAGI thresholds for making Roth contributions or the ability to convert Roth IRAs.

Given the potential problems, clients may want to avoid the Backdoor Roth. One alternative is to fund a nonqualified annuity with after-tax dollars. There is no contribution limit, the funds grow tax-deferred, and the annuity value can either be annuitized at retirement or even be used in a Section 1035 tax-free exchange to pay long-term care insurance premiums.

Roth IRAs offer many tax advantages. However, given the problems, clients should consult their tax attorney and CPA before engaging in a Backdoor Roth IRA.

[12] I.R.C. § 408(d)(6)(B)(iii).



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