



THE
DEFINITIVE
GUIDE
TO THE
“BACK-DOOR
ROTH”

By Jeffrey Levine, CPA

Ed Slott and Company, LLC

@IRAGuru4EdSlott



Chances are that you've heard of a retirement planning strategy known to many as the "Back-Door Roth." But what is it? Why is it important? What are the potential traps, and how can it benefit clients? In this special report, we dive deep into answering each of these questions and more.

But before we get into the meat and potatoes of our special report, it's important to note that the viability of the Back-Door Roth strategy is somewhat controversial. You can read our take below, but to be well-informed it's always best to get multiple viewpoints.

An Overview of the Back-Door Roth

Saying that the tax code is confusing, overly complicated – and in some cases makes no sense – is like saying that the sky is blue; it's pretty much a given. Case in point... the Roth IRA! Under our current tax law, any client with an IRA or other eligible retirement account can convert that account to a Roth IRA. It doesn't matter how old or young your client is. It doesn't matter how much income your client has, or for that matter, the source of the client's income (i.e. capital gains, earned income, Social Security benefits). And it doesn't matter how big or small your client's IRA or other eligible retirement account is.

So let's imagine that Bill Gates has a billion dollar IRA – after all, if anyone in the world could, it would be Gates – and that he wants to convert his billion dollar IRA to a billion dollar Roth IRA in order to eliminate RMDs (required minimum distributions) and allow it to grow tax-free for the balance of his life. He could do that.

Now, before suppose your clients are a husband and a wife who own a small retail shop. They typically work 6 – 7 days a week, putting in 12 – 14 hour days. At the end of the year, and after all their hard work and sacrifice, they make a combined \$200,000 of income. Here's the crazy thing. If this couple simply wanted to put \$5,500 directly into each of their Roth IRAs as a contribution to create a tax-free pot of money from which to pull from during retirement, they could not. In what is truly one of the more bizarre and unfair provisions in the tax code, Congress has placed income limits on the ability to make annual Roth IRA contributions (see chart on page 3), all while allowing unlimited amounts of money to flow into Roth IRAs via conversions.

Note: This is far from the only example of hypocrisy when it comes to the Roth rules and the tax code. For example, although high-income earners can be phased out of Roth IRA contributions, there are no similar income limits for salary deferrals to designated Roth accounts (DRAs), such as Roth 401(k)s and Roth 403(b)s.



At first glance, it would seem that for a client above the Roth IRA contribution income limits, getting new money (that was not previously in a different retirement account) into a Roth IRA each year would be an unachievable goal. However, thanks to yet another quirk in the tax code, that need not be true. Cue the Back-Door Roth IRA.

Simply put, the Back-Door Roth IRA allows clients to get new money into such an account who are phased out of making direct contributions to a Roth IRA. Instead of making contributions directly to a Roth IRA, the Back-Door Roth IRA calls for a work-around approach, where a contribution is made first to a traditional IRA and then converted to a Roth IRA.

Roth IRA Contributions

Of course, if a client wants to get new money into a Roth IRA on a regular basis and they are eligible to make a Roth IRA contribution, that's obviously going to be the first and best option. Thankfully, figuring out if a client is eligible to make a Roth IRA contribution is pretty easy. There are only two things you have to worry about:

1. Does the client (or his or her spouse) have compensation? Compensation, for Roth IRA contribution purposes, is generally earned income, such as W-2 wages or self-employment income, although it can also consist of other types of income, such as taxable alimony.
2. Is your client's income below their applicable inflation-adjusted threshold?

2016 Phase-out Range for Roth IRA Contribution Eligibility*

Single, Head of Household	\$117,000 - \$132,000
Married-Joint	\$184,000 - \$194,000
Married-Separate**	\$0 - \$10,000

*MAGI (modified adjusted gross income)

**Married couples filing separately can determine their IRA deduction eligibility using the "single" status, but ONLY if they did not live together for the ENTIRE year.

Other than those two potential roadblocks, there is nothing – I repeat – nothing that can prevent your client from making a valid Roth IRA contribution. In particular, note that there is no age limit for Roth IRA contributions. So, for instance, even Loren Wade – who is Walmart's oldest employee, having [just turned 103!](#) – can make a contribution to his Roth IRA this year, assuming he's under his applicable income threshold.



If the Front Door is Closed, Why Not Check and See if the Back Door is Open?

Implementing the Back-Door Roth IRA Strategy

Of course, many advisors work with clients who would like to make a Roth IRA contribution, but whose income exceeds their applicable threshold, preventing them from doing so. In such cases, the Back-Door Roth IRA might be able to provide an adequate solution. As noted above, the Back-Door Roth IRA is a two-step process.

Step #1 – The Traditional IRA Contribution

The first step in the Back-Door Roth IRA strategy is making a contribution to a traditional IRA. As such, a client must be able to legitimately make a contribution in order for the Back-Door Roth IRA to be a viable strategy. Similar to Roth IRAs, there are only two requirements to be able to make a traditional IRA contribution. They are:

1. Clients must have compensation, as discussed above.
2. Clients must not be age 70 ½ or older at the end of the year for which they are making the traditional IRA contribution.

Note that there are *no maximum income limits of any kind that can reduce or eliminate a client's ability to make a traditional IRA contribution. Furthermore, active participation in an employer-sponsored retirement plan has no impact on contribution eligibility* (though it may impact deductibility – more on that below). These are two common misconceptions held by clients, financial advisors and even their CPAs or other tax professionals.

Taxation of the IRA Contribution – In general, clients are entitled to an above-the-line deduction for amounts they contribute to a traditional IRA. In some cases, clients employing the Back-Door Roth IRA will be eligible to receive such a deduction (though after completing step #2 of the Back-Door Roth IRA strategy, that deduction will essentially be meaningless). That said, chances are that if you're executing the Back-Door Roth IRA strategy with a client, that client will not receive a deduction for their contribution. *But why?*

Although a client's income and active participation in an employer-sponsored retirement plan have no impact on their ability to contribute to a traditional IRA, a combination of the two may result in the phase-out of the IRA deduction for the contribution. For instance, if an IRA owner is an "active participant" in an employer-sponsored retirement



plan, their ability to claim a deduction for a contribution made to their traditional IRA will be phased out at the following income levels:

2016 Phase-out Range of IRA Contribution Deduction* IRA Owner Active Participant in Employer-Sponsored Retirement Plan

Single, Head of Household	\$61,000 - \$71,000
Married-Joint	\$98,000 - \$118,000
Married-Separate**	\$0 - \$10,000
*MAGI (modified adjusted gross income) **Married couples filing separately can determine their IRA deduction eligibility using the "single" status, but ONLY if they did not live together for the ENTIRE year.	

Note that other than the threshold for those filing married-separate (which is the same), the thresholds for deducting an IRA contribution when the IRA owner is an active participant in an employer-sponsored retirement plan are *lower* than the phase-out ranges the same client has for Roth IRA contribution eligibility purposes. Thus, if a client has been phased out of making a Roth IRA contribution directly and is an active participant in an employer-sponsored retirement plan, they will also be phased out of taking a deduction for a traditional IRA contribution.

If a client is married and their spouse is an active participant in employer-sponsored retirement plan (but they are not), this too can reduce or eliminate their ability to claim a deduction for a contribution made to their traditional IRA. The ability for such a non-active-participant-with-active-participant-spouse client to claim a deduction for an IRA contribution made to their traditional IRA is phased out at the following income levels:

2016 Phase-out Range of IRA Contribution Deduction* IRA Owner's Spouse is Active Participant in Employer-Sponsored Retirement Plan

Married-Joint	\$184,000 - \$194,000
Married-Separate**	\$0 - \$10,000
* MAGI (modified adjusted gross income) **Married couples filing separately can determine their IRA deduction eligibility using the "single" status, but ONLY if they did not live together for the ENTIRE year.	



Note that these phase-out ranges are identical to the phase-out ranges for Roth IRA contribution eligibility. Thus, if your client is over their Roth IRA contribution income limit threshold and either they or their spouse are an active participant in an employer-sponsored retirement plan, they will be phased out of taking a deduction for their traditional IRA contribution.

It's generally not that common to have clients who have earned income (or other forms of compensation) and are over their applicable Roth IRA contribution threshold, but neither spouse is an active participant in an employer-sponsored retirement plan. More often than not, high-income, working clients will be taking advantage of some sort of employer retirement plan.

Step #2 – The Roth IRA Conversion

Once your client has made a contribution to their traditional IRA, the next step in the Back-Door Roth IRA strategy is converting that contribution to a Roth IRA. If your client has no other IRA money at the time they execute this transaction, the deductibility – or lack thereof – of their traditional IRA contribution is a moot point. Either they will take a deduction for their IRA contribution, but will owe tax on those amounts upon conversion, or they will have no tax deduction for the contribution, and the resulting after-tax IRA funds will be converted tax-free.

Example #1: Pamela would like to make a Roth IRA contribution, but is above her applicable threshold, so she is utilizing the Back-Door Roth IRA strategy. Pamela actively participates in her employer's 401(k) plan, so she is phased out of taking a deduction for her traditional IRA contribution. If Pamela contributes \$5,500 to her traditional IRA, she will have no deduction and her contribution will go in as after-tax funds. A month later, when her IRA account has risen to \$5,600, Pamela converts her traditional IRA to a Roth IRA. Since \$5,500 of the \$5,600 converted consists of after-tax dollars, only the \$100 of gain will be taxable upon conversion. Thus, Pamela will have paid tax on a total of \$5,600, the entire balance of her Roth IRA at that point.

Example #2: Peter would like to make a Roth IRA contribution, but he is above his applicable threshold, so he is utilizing the Back-Door Roth IRA strategy. Peter is single, self-employed and has never established a retirement plan for his business. If Peter contributed \$5,500 to his traditional IRA he will be able to take a deduction for the contribution and it will go into his IRA as pre-tax funds. A month later, when his account has risen to \$5,600, Peter converts his traditional IRA to a Roth IRA. Since the



entire balance in his traditional IRA is pre-tax, Peter will owe tax on his entire \$5,600 conversion. Thus, Peter will have paid tax on a total of \$5,600 – the same as Pamela – in order to get \$5,600 into a Roth IRA.

As you can see, as long as a client has no money in an IRA prior to engaging in a Back-Door Roth IRA transaction, their tax bill be the same, whether they receive a deduction for the initial traditional IRA contribution or not. Things are not always so simple though. If a client has existing IRA money, the benefit of the Back-Door Roth IRA strategy can be greatly diminished in a client's eyes.

The Pro-Rata Rule Complication

The pro-rata rule dictates the taxation of an IRA distribution when the IRA owner has any IRA containing after-tax amounts. The rule states that, in general, an IRA distribution will consist of the same proportion of pre-tax and after-tax amounts as the IRA owner has in his or her IRA(s). Furthermore, for the purposes of this rule, all of a client's traditional IRAs – including SEP and SIMPLE IRAs – are looked at as one giant IRA.

Example #3: Jake has \$100,000 in his traditional IRA, \$10,000 of which is after-tax. Therefore, 10% ($\$10,000 / \$100,000 = 10\%$) of his traditional IRA consists of after-tax money. As a result, if Jake takes a distribution from his traditional IRA – including a Roth conversion – 10% of his distribution will be tax free and the balance will be taxable. So, for instance, if he wanted to convert \$20,000 of his traditional IRA to a Roth IRA, \$2,000 ($\$20,000 \times 10\% = \$2,000$) would be tax free and the remaining \$18,000 ($\$20,000 - \$2,000 = \$18,000$) would be taxable.

So how does this rule impact the Back-Door Roth IRA strategy and make it less attractive to clients? Consider the following example:

Example #4: Ann has \$95,000 in her traditional IRA, all of which is pre-tax. Recently, Ann's financial circumstances have changed so she is now phased out of making a Roth IRA contribution or from taking a deduction for a traditional IRA contribution. Ann, though, heard about the Back-Door Roth IRA from her friend Pamela (see example #1) and would like to do the same thing with a contribution of \$5,000. Unfortunately, it won't work out as well for her tax-wise.

If Ann makes a \$5,000 nondeductible (after-tax) contribution to a traditional IRA, her total IRA balance will be \$100,000, \$5,000 of which will be after-tax. Thus, 5% ($\$5,000 / \$100,000 = 5\%$) of any distribution Ann takes* – including a Roth IRA



conversion – will be a tax-free return of her after-tax amount. Note that this is the case regardless of whether Ann’s nondeductible IRA contribution is made to her existing IRA or a new IRA. If Ann were to convert \$5,000 from her traditional IRA to a Roth IRA after making her nondeductible contribution, just \$250 would be tax-free ($\$5,000 \times 5\%$), while the remaining \$4,750 ($\$5,000 - \$250 = \$4,750$) would be taxable. That’s probably not what Ann had in mind, especially since she would still owe tax on the \$5,000 she contributed to the traditional IRA (remember, she will have no deduction).

**Note: Certain distributions, such as distributions that are rolled into a 401(k) or similar plan, as well as qualified charitable distributions (QCDs) are not subject to the pro-rata rule.*

Step Transaction Concerns

The step-transaction doctrine is a judicial doctrine (it is not codified into law, but rather, interpreted by the courts) that stems largely from the more well-known doctrine of substance over form. The step-transaction doctrine, which can be traced all the way back to 1935 and the U.S. Supreme Court’s decision in *Gregory v. Helvering*, can be a bit complicated. Simply put, it is a legal principle that can allow one or more steps in an overall transaction to be ignored or multiple steps in an overall transaction to be combined and treated as a single step.

Unfortunately, since IRS and courts largely apply the step-transaction doctrine on a case-by-case basis, it is often difficult to say exactly whether or not a particular transaction will be considered a step transaction until it’s too late. Thus advisors must use a fair degree of professional judgment in situations where the doctrine could be imposed. Along those lines, there are some experts, such as noted blogger, speaker and industry leader Michael Kitces, who believe that [the Back-Door Roth IRA strategy constitutes a potential step transaction](#) and is something high-income clients ought to think twice about before implementing (at least before completing the Roth IRA conversion immediately or shortly after the traditional IRA contribution). Others, including myself and the rest of the Ed Slott and Company team, disagree and believe the Back-Door Roth IRA is a viable strategy — one that provides high-income clients a valuable and accessible benefit. This difference in opinion amongst experts has been around for some time, but for some reason, the Back-Door Roth IRA topic has become a hot button issue in the planning community as of late.

In practice, the courts have generally applied the step-transaction doctrine to transactions by using one of three tests: the *binding commitment test*, the *mutual interdependence test*, and the *end result test* (sometimes referred to as *the intent test*).



Neither the binding commitment, nor the mutual interdependence tests pose any sort of problem for the Back-Door Roth IRA strategy.

In applying the binding commitment test, the courts have traditionally looked to see whether a taxpayer has made a commitment to complete a later step in an overall transaction at the time a prior step is made. Clearly, if a client makes a traditional IRA contribution – whether it's deductible or not – there is absolutely no requirement that they complete a Roth IRA conversion of those funds. As a result, there's no question that the Back-Door Roth IRA passes this first test.

The second test that courts have used to determine if a series of transactions constitutes a step transaction is the mutual interdependence test. With this test, the courts have looked to see whether each step in a transaction has meaning (economic substance) on its own, or whether a specific step has no meaning unless later step(s) occur. There is absolutely zero question whether a traditional IRA contribution – whether deductible or not (non-deductible contributions still grow tax-deferred, for instance) – has meaning on its own. Thus, this test is also a non-issue.

The third and final test that is applied by the courts is the end result test. This is, admittedly, where things get a bit more complicated. Using the end result test, the courts look to determine if a series of steps were actually just predetermined steps of an overall transaction. If you are engaging in the Back-Door Roth IRA strategy, you're pretty much signaling your intent that you plan to use multiple steps to accomplish a goal, so understandably, this is the test that has concerned some practitioners.

With no absolute certainty to be had on the issue, that leaves it up to you to decide if the Back-Door Roth IRA strategy is appropriate. Is it a step-transaction... or not? Ultimately, that's a decision you will have to make, perhaps in consultation with other professionals, but here are just a handful of reasons why I don't lose any sleep at night when executing the Back-Door Roth IRA strategy with clients.

Reason #1 – Look Closely at How the Courts Have Described the Step Transaction

The step-transaction doctrine has been imposed in countless cases, but one of the most oft cited explanations of the doctrine comes from the 1982 Tax Court case *Smith v. Commissioner*. In its decision, the Tax Court offered up the following summation:

*“The step transaction doctrine generally applies in cases where a taxpayer seeks to get from point A to point D and does so stopping in between at points B and C. **The whole purpose of the unnecessary stops is to achieve tax consequences differing from those which***



a direct path from A to D would have produced. *In such a situation, courts are not bound by the twisted path taken by the taxpayer, and the intervening stops may be disregarded or rearranged.*” (emphasis added)

Reread the emphasized portion of the above quote... “The whole purpose of the unnecessary stops is to achieve tax consequences *differing from those which a direct path from A to D would have produced.*” There are two items you might choose to note. First, the whole issue here is that clients *can't go right from A to D.* If they could, they would! In other words, whereas the Tax Court was concerned about “unnecessary stops,” the traditional IRA contribution is a necessary step in this transaction. Second, the Tax Court was explicitly concerned with the taxpayer trying to secure *differing* tax consequences than would have been achieved if some of the middle steps were cut out. Here, however, with the Back-Door Roth IRA, the whole goal is to get tax treatment as close to the regular Roth IRA contribution as possible.

Reason #2 – No One Seems To Be Able To Cite A Single Court Case Where The IRS Attacked A Back-Door Roth IRA Using The Step-Transaction Doctrine

I've asked around to quite a few colleagues in the IRA and retirement community, and *no one can recall a single court case* where the IRS and a taxpayer debated the merits of the Back-Door Roth IRA. Sure, I've spoken with some who have “heard of a few people having problems with an IRS agent,” but that doesn't really carry much weight. For starters, IRS auditors are tasked with an impossibly difficult job; knowing, understanding and interpreting the complete tax code and regulations. No one can really do that well, so there are bound to be a few errors made here or there. With that in mind, it would be surprising not to hear of any problems ever coming up in this area (or any other, for that matter).

The outcome in those situations, of course, is highly dependent on the unique facts and circumstances of the case, as well as the skill of the CPA or other individual representing the taxpayers (including, perhaps, themselves). As most CPAs will tell you, if you put two different CPAs in front of the same auditor with the same background facts, chances are one will walk away from the audit with a better result for their client.

Reason #3 – The IRS Said Not To Worry About It

And if that's not yet enough of a reason to think the Back-Door Roth IRA strategy is viable, then consider the fact that the IRS has publically stated that the transaction is okay. IRS Spokesman Dean Patterson is quoted as saying, “There is no caveat about waiting.” This is a sentiment that I have heard echoed by a number of Treasury officials



during informal discussions. The IRS simply does not care how long you've had your money in a traditional IRA. As far as they are concerned, whenever you want to convert it to a Roth IRA, it's just fine with them.

Some professionals, like the aforementioned Kitces, don't place much value in the IRS' statement because they (correctly) point out that such a determination would ultimately have to be made by a court. That's true, but frankly, I find it to be of little concern for several reasons.

First, in order for the Tax Court to take up such an issue, it would actually have to come to the Court's attention. It seems unlikely, to say the least, that the IRS would challenge this transaction in Court, especially given its recent statements. But, even if the issue were to somehow manage to find its way to Court (say, for instance, a taxpayer challenged something else with respect to their tax return and the Tax Court just happened to "notice" the Back-Door Roth IRA) and the Court were to rule that the transaction was a step transaction, it probably wouldn't matter much anyway.

Consider [the *Bobrow* case](#) that shocked the IRA planning world. In the *Bobrow* decision, the Tax Court ruled that Alvin Bobrow had violated the once-per-year rollover rule, because, in its opinion, [the once-per-year rollover rule applies in aggregate to all of a client's IRAs](#). This was certainly not something the IRS had argued, as in its own publications it had contrary advice. Rather, it was just something the Tax Court kind of figured out on its own. So what did the IRS do? Did they invalidate all the rollovers that had previously been made following its faulty advice?

Not even close. Instead, the IRS chose not to challenge any previous rollovers that were correctly executed under its previous interpretation of the once-per-year rollover rule. That's not all though. The IRS actually took it a step further, giving people until the beginning of 2015 – almost a full year after the *Bobrow* decision was initially released – to continue following the old rules. If – and I still think it's a very unlikely if – the Tax Court were to ever invalidate the Back-Door Roth IRA strategy, it's extremely likely that the IRS would follow a similar course of action.

So in other words, even if I am wrong about the Back-Door Roth IRA, there's a really good chance it wouldn't matter anyway ... at least not right away.

Reason #4 - Recent Actions by President Obama and the IRS

Recent actions by President Obama and the IRS have both given tacit endorsements of the validity of the Back-Door Roth IRA strategy. In early February, President Barack



Obama released his [Fiscal Year 2016 Budget proposal](#). To the surprise of many, the [proposal contained a provision that would have virtually eliminated the Back-Door Roth IRA](#). Specifically, one of the many retirement account-related provisions in President Obama's budget called for limiting Roth IRA conversions to only pre-tax dollars. You don't really need to pass a law to ban something that's already illegal, so in some ways, this provision was actually a passive nod of approval of the Back-Door Roth IRA – at least with respect to its validity.

Additionally, in September of 2014 the IRS released Notice 2014-54, in which it enhanced the ability of participants of employer-sponsored retirement plans, like 401(k)s, to make tax-free conversions of their after-tax plan balances (more on this below). It would seem highly unlikely that the IRS would seek to expand opportunities for plan participants to make Roth IRA conversions of after-tax plan funds while simultaneously limiting IRA owners' abilities to complete similar transactions, thus giving more credence to the assumption that the IRS does not have an issue with the Back-Door Roth IRA.

The Best Defense to the Step-Transaction Doctrine ... Time

It's possible that even at this point you have some concerns about the step-transaction doctrine with respect to the Back-Door Roth Strategy. After all, you would not be alone in that regard. If that's that case, but you would like to help a client who is phased out of making Roth IRA contributions get money into a Roth IRA on a regular basis, all is not lost. There are a number of steps you can take to further reduce a client's possible exposure.

Nearly all practitioners – including myself – agree that the best defense against the step-transaction doctrine is time. The longer time you have between a series of steps, the harder it is for the IRS or courts to show that they are interrelated. On one extreme, some advisors are encouraging clients utilizing the Back-Door Roth IRA to make their contribution to their traditional IRA and complete the Roth IRA conversion of those funds on the same day. That is certainly not leaving a lot of time in between steps!

Same-day contribution/conversions may also lead to some practical issues from time to time. Although not common – or correct for that matter – some advisors have encountered custodians who have misreported such transactions as direct contributions to a Roth IRA to the IRS, creating unwarranted excess contribution problems for clients.

On the flip-side of the equation, some advisors recommend waiting significant amounts



of time in between a client's traditional IRA contribution and their Roth IRA conversion, in some cases up to a year or more (for the record, Michael Kitces has indicated he waits one year between contribution and conversion for clients in his practice). There's little question that doing so provides stronger protection from the step-transaction doctrine, if that's something you're concerned about, but it does come with a cost. The longer a client waits in between their traditional IRA contribution and their Roth IRA conversion, the greater their earnings will generally be – or at least one would hope! Thus, a quicker Roth IRA conversion allows for more – and potentially all – of the earnings on the contributed amount to grow tax-free in the Roth IRA.

Example #5: Nick is a high-income client who would like to use the Back-Door Roth IRA strategy to help him save for retirement. For the next 20 years, he plans to make a \$5,000 non-deductible contribution to his traditional IRA each year, followed shortly thereafter by a Roth conversion. Now imagine that you've found Nick a fantastic investment that pays him 1% interest each month, and that he is not concerned about a possible step transaction. If Nick waits one month in between his traditional IRA contribution and his Roth IRA conversion, he'll owe tax on an additional \$50 ($\$5,000 \times 1\% = \50) when he completes the conversion.

Nora, Nick's friend, is also a high-income client of yours who would like to use the Back-Door Roth IRA strategy to help her save for retirement. For the next 20 years, she plans to make a \$5,000 non-deductible contribution to her traditional IRA each year, followed shortly thereafter by a Roth conversion. Now imagine that you've found the same fantastic investment for Nora that pays her 1% interest each month. Furthermore, after speaking with her tax advisor, Nora has been advised to wait one year between her traditional IRA contribution and her conversion. If Nora does so, and converts each traditional IRA contribution to a Roth IRA after holding it in the traditional IRA for one year, she'll owe tax on an additional \$600 ($\$5,000 \times 12\% = \600)* when she completes the conversion. Nick, on the other hand, was able to accumulate the bulk of those earnings tax free in his Roth IRA.

**Note: For simplicity purposes, the calculation ignores the effect of compounding.*

So what's the ideal amount of time to wait in between a client's traditional IRA contribution and the Roth IRA conversion? There's really no right or wrong answer here. More is always better if a step transaction is something you're worried about. Conversely, if you have absolutely no qualms about running afoul of the doctrine, then a shorter traditional IRA "hold time" is preferable for the reasons just discussed.



What do we suggest? Every situation is different, but as a general guideline, we like to suggest clients executing the Back-Door Roth IRA wait to receive at least one statement showing the contribution was actually made to a traditional IRA. This minimizes the possibility that a custodian will engage in any creative – *errrr*, wrong – reporting.

What If?

By now, you may be wondering just what running afoul of the step transaction test could mean for a client. That depends on the transaction a client is engaging in, but in this case, if the step transaction test was applied – and again, our opinion is that there’s a minimal chance of that happening — the likely outcome would be that the amounts contributed to the client’s traditional IRA would be treated as though they had been contributed directly to their Roth IRA.

By virtue of the fact that a client is using the Back-Door Roth IRA in the first place, we know that a direct Roth IRA contribution would be impermissible. Thus, the client would be treated as having made an excess Roth IRA contribution. That contribution (and each of the Back-Door Roth IRA contributions) would be subject to a 6% excess contribution penalty for each year it (they) remained in the client’s Roth IRA. The IRS could also look to enforce other penalties, including the failure-to-pay penalty, the failure-to-file penalty and, if the amount was large enough, the 20% accuracy-related penalty.

Worse yet, since the excess contribution penalty is reported on IRS Form 5329, if that form has not been filed each year – and it almost certainly would not – there’d be [no statute of limitations](#) on these penalties, meaning the IRS could “catch on” five or ten years down the line – or longer – and assess the penalties retroactively for all previous years. With such potentially damaging consequences *if* a client’s Back-Door Roth IRA strategy was considered a step-transaction, out of an abundance of caution, some clients may wish to put lots of time in between their traditional IRA contribution and Roth IRA conversion – or avoid the strategy altogether – even if the likelihood of such an event is determined to be extremely low.

Always Get the Blessing of Your Client’s Tax Advisor

In some cases, you may serve as both financial and tax advisor to a client, but if your client also works with a CPA or other tax professional, it always best to get them on board with your Back-Door Roth IRA plans. For starters, it can help protect you, especially if you’re one of those advisors whose fine print says you are unable to provide tax advice. Not only that, but on the off chance that the validity of the transaction is questioned by the IRS or another entity, chances are it will be the CPA who is going to



represent your client and try to smooth things over. So best to have them on your side!

Custodial Tax Reporting for the Back-Door Roth IRA

If your client makes a contribution to their traditional IRA, the custodian should issue a 5498 to report that contribution. This is informational reporting only; it is issued in May of the year after the contribution is being made to both the IRA owner and to IRS. Note that the custodian has no responsibility to distinguish whether such a contribution is deductible or not. This is handled entirely on a client's personal tax return using either IRS Form 8606 to report a nondeductible contribution or IRS Form 1040 to report a deduction for such a contribution.

When the traditional IRA funds are later converted, the traditional IRA custodian will issue a 1099-R for the Roth IRA conversion. They will do this even if the funds go directly from the IRA to the Roth IRA. Once again, clients are responsible for reporting the tax impact of such a transaction on their personal returns using IRS Form 8606 and IRS Form 1040. Finally, the Roth IRA custodian will issue a 5498 showing the amount of the conversion received by the Roth IRA. From these documents, IRS will be looking for taxes due on the conversion. Similar to the Form 5498 issued by the traditional IRA custodian, this form is issued for information purposes only.

Potential Bonus Strategy – The “Mega Back-Door Roth”

If some is good, more is better, right? If you and your client feel comfortable with the Back-Door Roth IRA strategy and they have additional discretionary income, you may want to see if there's the potential to take this strategy to the next level with another related strategy that has been dubbed by some as the “Mega Back-Door Roth.” What is the Mega Back-Door Roth? Quite simply, it's the employer-sponsored retirement plan equivalent of the Back-Door Roth IRA. Since plan contribution limits are higher than IRA contribution limits, there's the potential, in limited circumstances, to facilitate a transaction similar to the Back-Door Roth IRA, but with much greater dollar amounts.

In order for a client to be able to take advantage of the Mega Back-Door Roth strategy, five conditions must be present:

1. The client's employer-sponsored retirement plan, such as their 401(k), must allow them to make after-tax contributions.
2. The after-tax contributions must pass the actual contribution percentage (ACP) test.



3. The client must be below the “overall limit” for plan contributions (\$53,000 in 2016, not including catch-up contributions).
4. The client must have enough disposable income to make after-tax contributions to their plan.
5. The plan must allow for periodic in-service distributions of the client’s after-tax money (and their earnings).

Here’s how the strategy works. In September 2014, IRS Notice 2014-54 clarified the tax treatment of distributions from plan funds when the plan contains both pre-tax and after-tax amounts. According to the Notice, distributions from such plans must be made on a pro-rata basis, but the pre-tax and after-tax portions of that distribution can be split, allowing the pre-tax money to be rolled to a traditional IRA while the after-tax portion is converted, tax free, to a Roth IRA. Here’s the thing, though. The pro-rata calculation for the distribution generally only includes funds a client is eligible to take a distribution of at the time. If there are certain funds to which a participant is not currently entitled, then those funds are not factored into the calculation.

With that in mind, a young (pre-59 ½) client can make after-tax contributions to their plan on an ongoing basis. Then, periodically and preferably before there are significant gains on those amounts, they can take a distribution of those funds and have them converted to a Roth IRA. Since the pre-tax and/or Roth salary deferrals they have, along with their earnings, would generally be inaccessible, the pro-rata calculation would typically only consider the client’s after-tax funds and their respective earnings. Therefore, the converted funds will be all or mostly after-tax money, and the conversion will be virtually tax-free. Chances are this is sounding a bit familiar.

Example #6: Kenny is 40 years old and works for an employer that offers a 401(K) plan allowing after-tax contributions to be made. Kenny has been employed by his company since he graduated from college. During that time, he’s made a total of \$140,000 of pre-tax salary deferrals. Together with their earnings, that sum has now grown to \$290,000. During a meeting with Kenny, who is looking to retire early and save as much as he can on a tax-favored basis, you review his plan document. You notice that Kenny is eligible to make after-tax contributions and that he can take a distribution of those amounts once annually. Furthermore, after looking at Kenny’s own salary deferrals and his company’s match, you determine he is eligible to contribute \$30,000 of after-tax money to his plan, and you suggest he do so to utilize the mega back-door Roth strategy.



Over the next few months, Kenny contributes the full \$30,000 of after-tax funds he is eligible to add to his 401(k) balance. By that time, the value of the after-tax contributions, along with their earnings (pre-tax) is \$33,000 and the value of his pre-tax salary deferrals and their earnings is \$300,000. Therefore, Kenny's total 401(k) balance is \$333,000, of which just \$30,000 is after-tax money.

Kenny then requests a distribution from his plan for the funds that he is currently eligible to receive. Since Kenny is under 59 ½ and is still working for the company, he is unable to access his salary deferrals and their earnings. In fact, the only funds Kenny is able to access at this time are his after-tax contributions and their earnings. As a result, despite the fact that Kenny has over \$300,000 in pre-tax money in his plan, the amount of pre-tax and after-tax money he receives as part of his distribution will typically be calculated based on the \$30,000 of after-tax money Kenny has contributed, along with the \$3,000 of earnings attributable to those funds.

If Kenny wants, he can request to have the entire amount directly rolled over to his Roth IRA, and he will owe tax on just \$3,000 of his \$33,000 conversion (since the rest is after-tax money). Similarly, if Kenny wants to avoid any additional taxation, he can use the guidance provided by Notice 2014-54 and request to have the \$3,000 of pre-tax earnings moved directly to a traditional IRA, while simultaneously converting his \$30,000 of after-tax funds to a Roth IRA tax-free. This can be done year after year, supersizing Kenny's Roth IRA account, with no additional tax cost.

Obviously, not all clients will have this opportunity, but for those who do, it can be quite powerful. Consider targeting clients who are small business owners. In addition to being more likely to have the necessary disposable income to make this strategy work, such clients are in the best position to facilitate amending plan documents to incorporate the provisions necessary to execute a mega back-door Roth transaction.