The Advanced Consulting Group

White paper

Retirement income planning using the "backdoor Roth IRA" and the "mega backdoor Roth IRA"

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I. Background

1.1. In this paper, we are describing a tax planning technique that has received a lot of attention from financial planners and tax advisors in recent years. We are not going to get into the merits of whether a Roth IRA is better than a traditional IRA for a given taxpayer; rather, we are assuming that the individual planning has been done and that a decision has been made to maximize the taxpayer's available Roth IRA assets. This paper discusses a couple of techniques to accomplish that planning goal.

1.2. The terms "backdoor Roth IRA" and "mega backdoor Roth IRA" are not found in the Internal Revenue Code ("IRC"); rather, they are colloquial terms used to describe a technique whereby funds are accumulated in a retirement vehicle other than a Roth IRA and later transferred to the Roth IRA. The differentiator between the backdoor and mega backdoor varieties of the transaction is in the accumulation vehicle. The backdoor Roth IRA accumulates its funds in a traditional IRA, whereas the mega backdoor Roth IRA accumulates its funds in a 401(k) plan or a 403(b) plan in the form of nondeductible (i.e., after-tax, but not Roth) employee contributions.

1.3. The first factor driving interest in the backdoor and mega backdoor Roth IRAs is the dollar limitation and the income limitation placed on taxpayers who desire to make contributions to a Roth IRA.

1.3.1. Under the "dollar limitation" the maximum annual contributions cannot exceed the maximum amount allowed as a deduction for a regular IRA (the limit applicable to that year or 100% of the individual's compensation)[1] reduced by the contributions for the taxable year to all other individual retirement plans maintained for the individual's benefit.[2] The maximum dollar limit is $6,000 for 2019. Individuals who are at least 50 years of age before the close of the tax year may make an additional catch-up contribution in the amount of $1,000 (unadjusted for inflation), so that the maximum becomes $7,000 for 2019.

1.3.2. IRC 408A(c)(3) provides a limitation on the ability of a taxpayer to make a contribution to his or her Roth IRA if the amount of the taxpayer's adjusted gross income ("AGI") exceeds certain amounts. For 2019, a taxpayer's Roth IRA contribution limit is reduced (phased out) between the lower dollar limit and the upper dollar limit and completely eliminated above the upper dollar limit.

A. Taxpayer's filing status is married filing jointly or qualifying widow(er) and his/her modified AGI is at least $193,000. The taxpayer can't make a Roth IRA contribution if his or her modified AGI is $203,000 or more.

B. Taxpayer's filing status is single, head of household, or married filing separately and he/she didn't live with his/her spouse at any time in 2019 and the modified AGI is at least $122,000. The taxpayer can't make a Roth IRA contribution if his/her modified AGI is $137,000 or more.

C. Taxpayer's filing status is married filing separately, he/she lived with his/her spouse at any time during the year, and his/her modified AGI is more than zero. Taxpayer can't make a Roth IRA contribution if his/her modified AGI is $10,000 or more.[3]

1.4. The second factor driving interest in the backdoor and mega backdoor Roth IRAs is the expanded rollover opportunities into Roth IRAs from traditional IRAs, qualified retirement plans, 403(b) plans, and governmental IRC 457(b) plans.[4] These rollover opportunities will be discussed in subsection 2.5.

II. The basics

2.1. Traditional IRAs. A taxpayer can open and make contributions to a traditional IRA if: (i) he/she (or, if the taxpayer files a joint return, the taxpayer's spouse) received taxable compensation during the year; and, (ii) the taxpayer was not age 70 ½ by the end of the year. A taxpayer can have a traditional IRA whether or not he/she is covered by any other retirement plan. However, the issue is whether the taxpayer and/or spouse can deduct contributions made to an IRA (all or partially) if the taxpayer or the spouse is covered by an employer retirement plan.[5] In this discussion of traditional IRAs, the subject of spousal IRAs was intentionally omitted.

2.1.1. Fully deductible contribution limits. If neither the taxpayer nor his/her spouse was covered for any part of the year by an employer retirement plan, the taxpayer can take a deduction for total contributions to one or more traditional IRAs of up to the lesser of: (i) $6,000 ($7,000 if taxpayer is age 50 or older); or (ii) 100% of taxpayer's compensation. This limit is reduced by any contributions made to a 501(c)(18) plan [trust or trusts created before June 25, 1959, forming part of a plan providing for the payment of benefits under a pension plan funded only by contributions of employees, if certain conditions are met] on the taxpayer's behalf.[6]

2.1.2. Taxpayer covered by plan at work. Effect of modified AGI on deductibility of IRA contribution if taxpayer is covered by a retirement plan at work, as found in Table 1-2, IRS Publication 590-A (2018, as modified by IRS Notice 2018-83 for 2019 limits).

A. Filing status - single or head of household and modified AGI of: (i) $64,000 or less, a full deduction; (ii) more than $64,000 but less than $74,000, a partial deduction; and (iii) $74,000 or more, no deduction.

B. Filing status - married filing jointly or qualifying widow(er) and modified AGI of: (i) $103,000 or less, a full deduction; (ii) more than $103,000 but less than $123,000, a partial deduction; and (iii) $123,000 or more no deduction.

C. Filing status - married filing separately and modified AGI of: (i) less than $10,000, a partial deduction; and (ii) $10,000 or more, no deduction.

2.1.3. Taxpayer not covered by a plan at work. Effect of modified AGI on deductibility of IRA contribution if taxpayer is not covered by a retirement plan at work, as found in Table 1-3, IRS Publication 590-A (2018, as modified by IRS Notice 2018-83 for 2019 limits).

A. Filing status - single, head of household, or qualifying widow(er): any amount of modified AGI, a full deduction.

B. Filing status - married filing jointly or separately with a spouse who isn't covered by a plan at work: any amount of modified AGI, a full deduction.

C. Filing status - married filing jointly with a spouse who is covered by a plan at work and modified AGI of: (i) $193,000 or less, a full deduction; (ii) more than $193,000 but less than $203,000, a partial deduction; and (iii) $203,000 or more, no deduction.

D. Filing status - married filing separately with a spouse who is covered by a plan at work and modified of: (i) less than $10,000, a partial deduction; and (ii) $10,000 or more, no deduction.

2.1.4. Social security recipients. Instead of using Table 1-2 or Table 1-3 to compute the deductible amount of an IRA contribution in the case of a taxpayer and/or spouse who is covered by a retirement plan at work, a special set of worksheets found in Appendix B of IRS Publication 590-A (2018, as modified by IRS Notice 2018-83 for 2019 limits) is used to compute the deductible amount if all of the following apply: (i) the taxpayer received social security benefits; (ii) the taxpayer received taxable compensation; (iii) contributions were made to the taxpayer's traditional IRA; and (iv) the taxpayer and/or his or her spouse were covered by an employer retirement plan.

2.1.5. Nondeductible contribution limits.[7] To the extent that a taxpayer is precluded making a deductible IRA contribution, he or she may make a nondeductible contribution to a traditional IRA up to the dollar limits (i.e., $6,000 for 2019, or $7,000 for 2019 in the case of a taxpayer age 50 and over by the end of the applicable year). To designate contributions as nondeductible, the taxpayer must file Form 8606. It is not necessary to designate a contribution as nondeductible until the filing of the tax return. When the taxpayer files, he or she can even designate otherwise deductible contributions as nondeductible contributions. The taxpayer must file Form 8606 to report nondeductible contributions even if the taxpayer did not to have to file a tax return for the year.

2.1.6. Distributions from traditional IRAs.[8] Distributions from a traditional IRA may be fully or partly taxable, depending on whether the IRA includes any nondeductible contributions.

A. Fully taxable. If only deductible contributions were made to the traditional IRA (or IRAs, if the taxpayer has more than one IRA), there is no basis in the IRA. Because there is no basis in the IRA, any distributions are fully taxable when received.

B. Partly taxable. If the taxpayer has made nondeductible contributions or rolled over any after-tax amounts to any of the taxpayer's traditional IRAs, he or she has a cost basis (investment in the contract) equal to the amount of those contributions. These nondeductible contributions aren't taxed when they are distributed; instead, they are treated as a return of the taxpayer's investment in his or her IRA. Only the part of the distribution that represents nondeductible contributions and rolled over after-tax amounts (taxpayer's cost basis) is tax free. If nondeductible contributions have been made or after-tax amounts have been rolled over to the taxpayer's IRA, distributions consist partly of nondeductible contributions (basis) and partly of deductible contributions, earnings, and gains (if there are any). Until all of a taxpayer's basis has been distributed, each distribution is partly nontaxable and partly taxable.[9]

C. Multiple IRAs of the taxpayer – minimum required distributions. If a taxpayer has more than one traditional IRA, he or she must determine a separate required minimum distribution for each IRA. However, the IRS says that a taxpayer can total these minimum amounts and take the total from any one or more of the IRAs.

2.2. Roth IRAs.[10] A Roth IRA is an individual retirement plan that, except as discussed in this subsection 2.2, is subject to the rules that apply to a traditional IRA. It can be either an account or an annuity. To be a Roth IRA, the account or annuity must be designated as a Roth IRA when it is opened. A deemed IRA can be a Roth IRA, but neither a SEP IRA nor a SIMPLE IRA can be designated as a Roth IRA. Unlike a traditional IRA, the taxpayer can't deduct contributions to a Roth IRA. However, if the Roth IRA requirements are satisfied, qualified distributions (see paragraph 2.2.3) are tax free. Contributions can be made to the Roth IRA after the owner reaches age 70 ½, and the owner can leave amounts in his or her Roth IRA as long as the owner lives.

2.2.1. Roth IRA contribution limits.[11] The contribution limit for Roth IRAs generally depends on whether contributions are made only to Roth IRAs or to both traditional IRAs and Roth IRAs. If contributions are made only to Roth IRAs, the contribution limit generally is the lesser of: (i) $6,000 ($7,000 if the owner is age 50 or older); or (ii) the owner's taxable compensation. However, if the owner's modified AGI is above a certain amount, the contribution limit may be reduced, as explained later under paragraph 2.2.2. If contributions are made to both Roth IRAs and traditional IRAs established for the owner's benefit, the contribution limit for Roth IRAs generally is the same as the limit would be if contributions were made only to Roth IRAs, but then reduced by all contributions for the year to all IRAs other than Roth IRAs.

2.2.2. Income limitations. The ability of a taxpayer to make a Roth IRA contribution is affected by the amount of the taxpayer's modified adjusted gross income (modified AGI).[12] The income limitation is the only limitation affecting the taxpayer's ability to make a Roth IRA contribution. Unlike a traditional IRA where there is a restriction placed on the taxpayer's ability to make a deductible contribution if the taxpayer and/or his or her spouse participate in an employer retirement plan, there is no such limitation in the case of a Roth IRA.

A. Filing status - married filing jointly or qualifying widow(er); modified AGI less than $193,000, taxpayer can contribute up to $6,000 ($7,000 if you are age 50 or older). If the taxpayer's modified AGI is at least $193,000 but less than $203,000, the amount the taxpayer can contribute is reduced. If the taxpayer's modified AGI is $203,000 or more, the taxpayer can't contribute to a Roth IRA.

B. Filing status - married filing separately (and you lived with your spouse at anytime during the year); modified AGI is zero (-0-), the taxpayer can contribute up to $6,000 ($7,000 if you are age 50 or older). If the taxpayer's modified AGI is more than zero (-0-) but less than $10,000, the amount the taxpayer can contribute is reduced. If the taxpayer's modified AGI is $10,000 or more, he or she can't contribute to a Roth IRA.

C. Filing status - single, head of household, or married filing separately (and you didn't live with your spouse at any time during the year); modified AGI is less than $122,000, the taxpayer can contribute up to $6,000 ($7,000 if you are age 50 or older). If the modified AGI is at least $122,000 but less than $137,000, the amount the taxpayer can contribute is reduced. Finally, if the taxpayer's modified AGI is $137,000 or more, the taxpayer can't contribute to a Roth IRA.

2.2.3. Qualified distributions. A qualified distribution is any payment or distribution from the IRA owner's Roth IRA that meets the following requirements.[13] It is made after the five-year period beginning with the first taxable year for which a contribution was made to a Roth IRA set up for the owner's benefit, and the payment or distribution is:
A. made on or after the date the IRA owner reaches age 59 ½;
B. made because the IRA owner is disabled;
C. made to a beneficiary or to the IRA owner's estate after his or her death; or
D. one that meets the requirements of the first home (build, buy, rebuild) exception (up to a $10,000 lifetime limit).

2.3. Conversions. In a conversion transaction, the IRA owner of a traditional IRA converts all or a portion of that traditional IRA into a Roth IRA. The ability to make a conversion allows the affected taxpayer the opportunity to engage in some tax planning in terms of the timing of recognizing income. For tax years beginning after 2009, the $100,000 modified AGI limit (before any inflation adjustments) on conversions of traditional IRAs to Roth IRAs no longer applies. In addition, married taxpayers filing a separate return are now able to convert amounts in a traditional IRA into a Roth IRA. Thus, after 2009, taxpayers may make such conversions without regard to their AGI.[14] Following is a summary of the rules applicable to conversions, as set forth in IRS Publication 590-A (2018).

2.3.1. Allowable conversions. The IRA owner can withdraw all or part of the the assets from a traditional IRA and reinvest them (within 60 days) in a Roth IRA. The amount that is withdrawn and timely contributed (converted) to the Roth IRA is called a conversion contribution. If properly (and timely) rolled over, the 10% additional tax on early distributions won't apply. However, a part or all of the distribution from the taxpayer's traditional IRA may be included in gross income and subjected to ordinary income tax. The same property received from the traditional IRA must be rolled over into the Roth IRA. The owner can roll over part of the withdrawal into a Roth IRA and keep the rest of it. The amount that the owner keeps will generally be taxable (except for the part that is a return of nondeductible contributions) and may be subject to the 10% additional tax on early distributions. The one-year rule (discussed in paragraph 2.5.3) does not apply to conversions from a traditional IRA to a Roth IRA.

2.3.2. Conversion methods. The IRA owner may convert amounts from a traditional IRA to a Roth IRA in any of the following three ways.

A. Rollover. The IRA owner can receive a distribution from a traditional IRA and roll it over (contribute it) to a Roth IRA within 60 days after the distribution.

B. Trustee-to-trustee transfer. The IRA owner can direct the trustee of the traditional IRA to transfer an amount from the traditional IRA to the trustee of the Roth IRA.

C. Same trustee transfer. If the trustee of the traditional IRA also maintains the Roth IRA, the IRA owner can direct the trustee to transfer an amount from the traditional IRA to the Roth IRA.

2.3.3. Periodic distributions. If the IRA owner started taking substantially equal periodic payments from his or her traditional IRA, the owner can convert the amounts in the traditional IRA to a Roth IRA and then continue the periodic payments. The 10% additional tax on early distributions won't apply even if the distributions aren't qualified distributions (as long as they are part of a series of substantially equal periodic payments).

2.3.4. Required distributions. The IRA owner can't convert amounts that must be distributed from his or her traditional IRA for a particular year (including the calendar year in which the owner reaches age 70 ½) under the required distribution rules.

2.3.5. Income. The owner of the traditional IRA must include in his or her gross income distributions from the traditional IRA that the owner would have had to include in income if the owner hadn't converted them into a Roth IRA. These amounts are normally included in income on the owner's return for the year that the owner converted them from a traditional IRA to a Roth IRA. Any part of the distribution from the traditional IRA that is a return of basis is not included in gross income.

2.4. Recharacterizations. A recharacterization allows the IRA owner to treat a regular contribution made to a Roth IRA or to a traditional IRA as having been made to the other type of IRA. A regular contribution is the annual contribution the IRA owner is allowed to make to a traditional or Roth IRA: up to $6,000 for 2019, $7,000 if the IRA owner is age 50 or older. It does not include a conversion or any other rollover. Following is a summary of the rules applicable to recharacterizations, as set forth in IRS Publication 590-A (2018).

2.4.1. Recharacterization process. To recharacterize a contribution, the IRA owner generally must have the contribution transferred from the first IRA (the one to which it was made) to the second IRA in a trustee-to-trustee transfer. If the transfer is made by the due date (including extensions) for the owner's tax return for the tax year for which the contribution was made, the owner can elect to treat the contribution as having been originally made to the second IRA instead of to the first IRA. To properly recharacterize a contribution, all three of the following must be done: (i) include in the transfer any net income allocable to the contribution and, if there was a loss, the net income that must be transferred may be a negative amount; (ii) the IRA onwer reports the recharacterization on his or her tax return for the year during which the contribution was made; and (iii) treat the contribution as having been made to the second IRA on the date that it was actually made to the first IRA.

2.4.2. No recharacterizations of conversions made in 2018 or later. A conversion of a traditional IRA to a Roth IRA, and a rollover from any other eligible retirement plan to a Roth IRA, made in tax years beginning after December 31, 2017, cannot be recharacterized as having been made to a traditional IRA. This change in the law has reduced some of the planning flexibility that previously existed with respect to conversion planning. If the IRA owner made a conversion in the 2017 tax year, he or she has until the due date (with extensions) for filing the return for that tax year to recharacterize it.

2.4.3. No deduction allowed. The IRS indicates that the taxpayer can't deduct the contribution to the first IRA. This would be the case if the first IRA were a Roth IRA and it would also be the case if the first IRA were a traditional IRA because the transfer to the Roth IRA as part of the recharacterization process must take place by the due date (including extensions) of the IRA owner's tax return for the year in question. The IRS also states that any net income transferred with the recharacterized contribution is treated as earned in the second IRA. The IRS emphasizes that the recharacterization contribution won't be treated as having been made to the second IRA to the extent any deduction was allowed for the contribution to the first IRA.

2.4.4. Conversion by rollover from traditional to Roth IRA. Assume that the IRA owner receives a distribution from a traditional IRA in one tax year. The IRA owner then rolls it over into a Roth IRA within 60 days of the distribution from the traditional IRA but in the next year. The IRS states that for recharacterization purposes, the IRA owner would treat this transaction as a contribution to the Roth IRA in the year of the distribution from the traditional IRA.

2.4.5. Effect of previous tax-free transfers. If an amount has been moved from one IRA to another in a tax-free transfer, such as a rollover, the IRA owner generally can't recharacterize the amount that was transferred. However, if the IRA owner has mistakenly rolled over or transferred an amount from a traditional IRA to a SIMPLE IRA, it is permissible to later recharacterize the amount as a contribution to another traditional IRA.

2.4.6. Reporting a recharacterization. If an IRA owner elects to recharacterize a contribution to one IRA as a contribution to another IRA, the owner must report the recharacterization on his or her tax return as directed by Form 8606 and its instructions. The contribution must be treated as having been made to the second IRA.

2.5. IRA Rollovers. The following summary of rollovers is adapted from the discussion on rollovers as set forth in IRS Publication 590-A (2018). Generally, a rollover is a tax-free distribution to the account owner of cash or other assets from one retirement plan that such person contributes to another retirement plan within 60 days of the owner's receipt of the payment or distribution. The contribution to the second retirement plan is called a "rollover contribution."

2.5.1. Rollovers to a traditional IRA. Amounts from the following plans may be rolled into a traditional IRA: (i) a traditional IRA; (ii) an employer's qualified retirement plan for its employees [IRC 401(a) plan]; (iii) a deferred compensation plan of a state or local government [Governmental IRC 457(b) plan]; and (iv) a tax-sheltered annuity plan [IRC 403(b) plan].

2.5.2. Rollovers from a traditional IRA into an eligible retirement plan. An IRA owner may be able to roll over, tax free, a distribution from his or her traditional IRA into an eligible retirement plan. The term "eligible retirement plan" for this purpose includes: (i) the Federal Thrift Savings Fund (for federal employees); (ii) IRAs; (iii) deferred compensation plans of state or local governments [Governmental IRC 457(b) plans]; (iv) tax-sheltered annuity plans [IRC 403(b) plans]; and (v) retirement plans qualified under IRC 401(a) and 403(a). These eligible retirement plans may, but are not required to, accept rollover contributions.

2.5.3. Rollovers from one traditional IRA into another traditional IRA. An IRA owner can withdraw, tax free, all or part of the assets from one traditional IRA if the assets are reinvested within 60 days in the same or another traditional IRA. Because this is a rollover, there is no deduction of the amount that is reinvested in an IRA. Generally, if an IRA owner makes a tax-free rollover of any part of a distribution from a traditional IRA, such owner can't, within a one-year period, make a tax-free rollover of any later distribution from that same IRA. Nor can such IRA owner make a tax-free rollover of any amount distributed, within the same one-year period, from the IRA into which he or she made the tax-free rollover. The one-year period begins on the date the IRA owner receives the IRA distribution, not on the date it is rolled over into an IRA. Rules apply to the number of rollovers an owner can have with his or her traditional IRAs. An IRA owner can make only one rollover from an IRA to another (or the same) IRA in any one-year period regardless of the number of IRAs that such person owns. The limit is applied by aggregating all of an individual's IRAs, including SEP and SIMPLE IRAs as well as traditional and Roth IRAs, effectively treating them as one IRA for purposes of the limit. However, trustee-to-trustee transfers between IRAs aren't limited and rollovers from traditional IRAs to Roth IRAs (conversions) aren't limited.

2.5.4. Rollovers from one Roth IRA into another Roth IRA. Generally speaking, the same rules that apply in the case of a rollover from one traditional IRA into another traditional IRA also apply in the case of a rollover from one Roth IRA into another Roth IRA. The following rules apply:
A. the 60-day rule; assets must be reinvested in another Roth IRA within 60 days of distribution;
B. the one-year rule; no more than one tax-free rollover in any one-year period;
C. the special rules for property distributions; same property that is distributed must be rolled over;
D. the irrevocable rollover election rule; the IRS requires that the receiving Roth IRA trustee obtain a written, irrevocable election from the Roth IRA owner indicating that the contribution will be treated as a rollover transaction for federal income tax purposes. That is the case even when the rollover contribution is coming from another Roth IRA (even if made by a trustee-to-trustee transfer).[15]

2.5.5. Rollovers from a traditional IRA into a Roth IRA. This process is a conversion (discussed in subsection 2.3).

2.5.6. Rollovers from a Roth IRA to a traditional IRA. This is mentioned as a potential scenario, but, outside of a recharacterization (discussed in subsection 2.4), would likely never occur.

2.5.7. Rollovers from an employer plan to a Roth IRA. Effective for distributions after 2007, rollovers from a qualified plan [IRC 401(a)], a tax-sheltered annuity plan [IRC 403(b)], or a governmental IRC 457(b) plan to a Roth IRA are permitted and are called "qualified rollover contributions."[16] The taxable portion of the rollover amount would be taxable at the time of the rollover.[17]

2.5.8. Miscellaneous IRA rollover rules.

A. The same property that is distributed from one IRA must be the property that is rolled over to the new IRA.

B. An IRA owner may withdraw assets from a traditional IRA and can roll over part of the withdrawal tax free and keep the rest of it. The amount retained by the owner will generally be taxable (except for the part that is a return of nondeductible contributions). The amount retained by the owner may be subject to the 10% additional tax on early distributions.

C. Amounts that must be distributed during a particular year under the required distribution rules aren't eligible for rollover treatment.

D. If a person inherits a traditional IRA from his or her spouse, such person has the choice of rolling it over or choosing to make the inherited IRA his or her own.

E. If, instead of pursuing the rollover transaction, the IRA owner desires to directly transfer assets from one IRA (traditional or Roth) to another IRA (traditional or Roth), the 60-day and one-year rules do not apply to direct transfers.

III. Backdoor Roth IRA technique

3.1. Description of the technique. A taxpayer's ability to make a regular (not rollover) Roth IRA contribution is affected by the amount of his or her AGI, as described above in paragraph 2.2.2. For tax years after 2009, a conversion of a traditional IRA to a Roth IRA may be made without regard to the taxpayer's modified AGI (see the discussion in section 2.3). Thus, the backdoor Roth IRA technique involves a conversion of contributions made to a traditional IRA into a Roth IRA; and, due to TIPRA's (see footnote 14) repeal of the modified AGI limits on rollover contributions to a Roth IRA, taxpayers whose modified AGI would have exceeded limits previously in place that restricted their ability to make a rollover contribution to a Roth IRA are now free to do so.

3.2. Annual contributions to a traditional IRA followed by a rollover to a Roth IRA. The backdoor Roth IRA strategy is initiated by a taxpayer making an annual nondeductible contribution to a traditional IRA. Following the nondeductible contribution to the traditional IRA, the taxpayer then effects a conversion of that amount (most likely within the same tax year) to a Roth IRA. A taxpayer could make deductible contributions (if eligible – see the discussion in paragraphs 2.1.1 – 2.1.4), but if the intent of the taxpayer is to engage in the backdoor Roth IRA technique, it would make more sense for the taxpayer to make nondeductible contributions to the traditional IRA. In that way, the conversion of the traditional IRA balance consisting of nondeductible contributions would trigger only a minimal tax (if any) upon the conversion to a Roth IRA, due to any earnings on the nondeductible contributions prior to the date of conversion. Upon conversion, the affected taxpayer would have to include in his or her taxable income only the earnings on the amount of the nondeductible contributions. Another reason for making nondeductible contributions to the traditional IRA is that if the taxpayer (see paragraph 2.1.2) or the taxpayer's spouse (see paragraph 2.1.3) is covered by a retirement plan and the income exceeds certain limits, a deductible contribution to the traditional IRA will be precluded.

3.3. Rollover contributions of seasoned money in a traditional IRA to a Roth IRA. As noted in paragraph 2.3.1, there are no limits on the amount of a traditional IRA that may be converted to a Roth IRA.

3.4. IRA aggregation rule. IRC 408(d)(1) provides that any amount paid out of a traditional IRA shall be taxed in the manner described in IRC 72 (general rule for the taxation of annuities, IRAs, and qualified retirement plans). IRC 408(d)(2) is known as the "IRA aggregation rule" and it states that for purposes of applying IRC 72 to any traditional IRA distribution: (i) all individual retirement plans shall be treated as one contract; (ii) all distributions during any taxable year shall be treated as one distribution; and (iii) the value of the contract, income on the contract, and investment in the contract shall be computed as of the close of the calendar year in which the taxable year begins.

3.4.1. Impact on the backdoor Roth IRA technique. If the taxpayer in question has multiple traditional IRAs in place that might include prior years' deductible IRA contributions and/or rollovers from 401(k) plans or other employer-sponsored retirement plans, it will be necessary to combine all IRA account balances into one for purposes of figuring the tax on the conversion transaction. This affects the backdoor Roth IRA technique by effectively negating the ability of a taxpayer to make nondeductible contributions to one traditional IRA contract and then converting those nondeductible contributions to a Roth IRA while only having to include in income the earnings on those nondeductible contributions. Due to the IRA aggregation rule, all IRA accounts of the affected taxpayer are considered when determining the tax consequences of the conversion to the Roth IRA and any after-tax contributions come out along with any pre-tax assets (whether contributions or earnings) on a pro rata basis. Thus, it is impossible in the case of a taxpayer with multiple IRA accounts to convert just the nondeductible contributions to a Roth IRA.

3.4.2. Extent of the application of the IRA aggregation rule. IRC 408A(d)(4)(A) (dealing with aggregation rules involving Roth IRAs) provides that IRC 408(d)(2) [the IRA aggregation rule] shall be applied separately with respect to Roth IRAs and other individual retirement plans. Thus, Roth IRAs are not aggregated with traditional IRAs of a taxpayer for purposes of the IRA aggregation rule.

3.4.3. Example of the IRA aggregation rule impacting a Roth IRA conversion transaction. Assume that the taxpayer has accumulated IRA assets attributable to deductible contributions and rollovers of pre-tax amounts equal to $200,000. Also assume that the taxpayer establishes in the current tax year a new traditional IRA for the sole purpose of accumulating nondeductible contributions for later conversion to a Roth IRA (i.e., the backdoor Roth IRA technique) and makes a $6,000 nondeductible contribution thereto. When the taxpayer triggers the Roth IRA conversion on the $6,000 nondeductible contribution (assume for this example that that are no earnings), only 2.91% of the $6,000 conversion amount ($174.60) will be nontaxable. This is so because $6,000 divided by $206,000 equals 2.91% (rounded). That percentage is then applied against the $6,000 amount being converted to determine the dollar amount that will not be taxed as part of the conversion process.

3.4.4. One planning strategy to avoid the application of the IRA aggregation rule to a backdoor Roth transaction. If the affected taxpayer is a participant in a qualified retirement plan [IRC 401(a); i.e., no SEPs under IRC 408(k) and no SIMPLEs under IRC 408(p)] and if that plan allows rollovers from IRAs (note — the qualified retirement plan does not have to allow for IRA rollovers), then the taxpayer can clean out the taxable assets from his or her traditional IRAs by rolling them into the qualified retirement plan. Under the IRA aggregation rule, qualified retirement plan assets are not aggregated, but the assets of a taxpayer that are held in a SEP or SIMPLE IRA are aggregated because these plans are IRA-based arrangements; therefore, to avoid the IRA aggregation rule and its pro rata nontaxable/taxable treatment of distributed assets on their conversion to a Roth IRA, these assets will have to be rolled as well. Under IRC 408(d)(3)(A)(ii), the qualified retirement plan may not accept rollovers of after-tax assets. The planning strategy of rolling taxable assets in IRA accounts into the affected qualified retirement plan operates to clear out the taxable assets from the IRA accounts prior to initiating the Roth IRA conversion, which can then be accomplished without triggering any taxable income.

3.4.5. IRS explanation of planning strategy outlined in paragraph 3.4.4. "Ordinarily, when you have basis in your IRAs, any distribution is considered to include both nontaxable and taxable amounts. Without a special rule, the nontaxable portion of such a distribution couldn't be rolled over. However, a special rule treats a distribution you roll over into an eligible retirement plan as including only otherwise taxable amounts if the amount you either leave in your IRAs or don't roll over is at least equal to your basis. The effect of this special rule is to make the amount in your traditional IRAs that you can roll over to an eligible retirement plan as large as possible."[18]

3.5. Potential issues triggered by the step transaction doctrine. At least one author[19] has raised the concern that the IRS could consider the separate transaction of making a nondeductible IRA contribution to a traditional IRA, followed closely by a Roth IRA conversion (i.e., the backdoor Roth IRA technique), as a "step transaction." If the IRS were to consider the backdoor Roth IRA transaction as a step transaction, then the author suggests that the IRS might argue that the consolidated transaction violates the otherwise applicable rules on Roth IRA contributions.

3.5.1. "Step transaction doctrine" defined. The step transaction doctrine is a judicial doctrine in the United States that combines a series of formally separate steps, resulting in tax treatment as a single integrated event. The doctrine is often used in combination with other judicial doctrines, such as substance over form. The step transaction doctrine originated from a common law principle in *Gregory v. Helvering*, 293 U.S. 465 (1935), which allowed the court to recharacterize a tax-motivated transaction. The doctrine states: "… interrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction. By thus linking together all interdependent steps with legal or business significance, rather than taking them in isolation, federal tax liability may be based on a realistic view of the entire transaction."[20]

3.5.2. Components of the step transaction doctrine. The following description of the components comprising the step transaction doctrine is found in the case of *Security Industrial Insurance Company, Plaintiff-Appellee v. United States of America, Defendant-Appellant* (CA-5), U. S. Court of Appeals, 5th Circuit, Nos. 81-3804, 81-3805, 702 F2d 1234, 4/22/83. The step transaction doctrine is a corollary of the general tax principle that the incidence of taxation depends upon the substance of a transaction rather than its form. Under the step transaction doctrine, the tax consequences of an interrelated series of transactions are not to be determined by viewing each of them in isolation but by considering them together as component parts of an overall plan. As articulated in the *Security Industrial Insurance Company* case, courts apply three component tests in determining whether the step transaction doctrine applies to a given transaction.

A. The test most often invoked in connection with the application of the step transaction doctrine is the "end result" test. Under this test, purportedly separate transactions are to be amalgamated when the successive steps were designed and executed as part of a plan to achieve an intended result.

B. A second test for determining whether the step transaction doctrine applies is labelled the "interdependence" test. The "interdependence" test for applying step transaction analysis asks whether the individual steps in a series had independent significance or whether they had meaning only as part of the larger transaction. This test concentrates on the relationship between the steps, rather than on their "end result."

C. The third and most restrictive test permitting invocation of the step transaction doctrine is the "binding commitment" test, as further enunciated in *Commissioner v. Gordon*, 391 U. S. 83, 88 S. Ct. 1517, 20 L. Ed. 2d 448 (1968), when the Court refused to aggregate stock distributions occurring several years apart for tax purposes. The *Gordon* Court commented that "if one transaction is to be characterized as a 'first step' there must be a binding commitment to take the later steps." *Id.* at 96, 88 S. Ct. at 1524. Thus the "binding commitment" test requires telescoping several steps into one transaction only if a binding commitment existed as to the second step at the time the first step was taken.

3.5.3. Potential nonapplicability of the step transaction doctrine to the backdoor Roth IRA technique. The concern about the possible application of the step transaction doctrine to the backdoor Roth IRA technique was, perhaps, more real prior to the enactment of the Tax Cuts and Jobs Act.[21] Certain language found in the Conference Report for P.L. 115-97 (published December 15, 2017), along with applicable footnotes, sheds some favorable light on the backdoor Roth IRA technique.

A. "Individuals with AGI below certain levels may make nondeductible contributions to a Roth IRA. The maximum annual contribution that can be made to a Roth IRA is phased out for taxpayers with AGI for the taxable year over certain indexed levels.268"[22]

Footnote. "268. Although an individual with AGI exceeding certain limits is not permitted to make a contribution directly to a Roth IRA, the individual can make a contribution to a traditional IRA and convert the traditional IRA to a Roth IRA, as discussed below."

B. "Taxpayers generally may convert an amount in a traditional IRA to a Roth IRA.269"[23]

Footnote. "269. Although an individual with AGI exceeding certain limits is not permitted to make a contribution directly to a Roth IRA, the individual can make a contribution to a traditional IRA and convert the traditional IRA to a Roth IRA."

C. "The House bill repeals the special rule that allows IRA contributions to one type of IRA (either traditional or Roth) to be recharacterized as a contribution to the other type of IRA. Thus, for example, under the provision, a conversion contribution establishing a Roth IRA during a taxable year can no longer be recharacterized as a contribution to a traditional IRA (thereby unwinding the conversion).276"[24]

Footnote. "276. The provision does not preclude an individual from making a contribution to a traditional IRA and converting the traditional IRA to a Roth IRA. Rather, the provision would preclude the individual from later unwinding the conversion through a recharacterization."

D. "The conference agreement follows the House bill and the Senate amendment with a modification. Under the provision, the special rule that allows a contribution to one type of IRA to be recharacterized as a contribution to the other type of IRA does not apply to a conversion contribution to a Roth IRA. Thus, recharacterization cannot be used to unwind a Roth conversion. However, recharacterization is still permitted with respect to other contributions. For example, an individual may make a contribution for a year to a Roth IRA and, before the due date for the individual's income tax return for that year, recharacterize it as a contribution to a traditional IRA.277"[25]

Footnote. "277. In addition, an individual may still make a contribution to a traditional IRA and convert the traditional IRA to a Roth IRA, but the provision precludes the individual from later unwinding the conversion through a recharacterization."

Bottom line — The Conference Report for the Tax Cuts and Jobs Act may be read to mitigate concern over possible application of the step transaction doctrine to the backdoor Roth IRA technique.

3.6. Reporting of the transaction. IRS 2018 Form 8606 [Nondeductible IRAs] is used to report the nondeductible contribution made to the traditional IRA, as well as the conversion thereof to the Roth IRA. Part I of the form is used to enter both the nondeductible contributions made to a traditional IRA, as well as any distributions, including the taxable amount, which the instructions say to report on 2018 Form 1040, line 4b. Part II of the form must be completed if part or all of a traditional, SEP, or SIMPLE IRA was converted to a Roth IRA in 2018. The instructions also state that any taxable amount of a conversion is to be reported on 2018 Form 1040, line 4b.

IV. Qualified Roth Contribution Program ("QRCP")

4.1. Another Roth option. A taxpayer who is either precluded from making a direct Roth IRA contribution because of the income limitations or who is not excited about the low dollar amounts ($6,000 + $1,000 catch-up) associated with annual contributions to a Roth IRA may have an option that should be considered before pursuing the mega backdoor Roth IRA (described in Section V below). If that taxpayer is a participant in an "applicable retirement plan" (defined in paragraph 4.2.2) that allows for elective deferrals (defined in paragraph 4.2.1) and that has a designated Roth account ("DRA") feature, such taxpayer may wish to consider first taking full advantage of the opportunities associated with that plan prior to pursuing the mega backdoor Roth IRA.

4.2. QRCP defined. The term "qualified Roth contribution program" ("QRCP") means a program under which an employee may elect to make designated Roth contributions in lieu of all or a portion of elective deferrals the employee is otherwise eligible to make under the applicable retirement plan.[26] A QRCP is a permissive feature that the sponsor of the applicable retirement plan must elect to add; it is not something that a plan participant can control. A program will not be treated as a QRCP unless the applicable retirement plan establishes separate accounts (DRAs) for the designated Roth contributions of each employee and any earnings properly allocable to the contributions and maintains separate recordkeeping with respect to each account.[27]

4.2.1. The term "elective deferral"[28] for purposes of treating such deferral as a Roth contribution means:

A. any elective deferral described in IRC 402(g)(3)(A) [any employer contribution under a qualified cash or deferred arrangement (as defined in IRC 401(k)] to the extent not includible in gross income for the taxable year under IRC 402(e)(3) [cash or deferred arrangement], determined without regard to IRC 402(g);

B. any elective deferral described in IRC 402(g)(3)(C) [any employer contribution to purchase an annuity contract under IRC 403(b)] under a salary reduction agreement, within the meaning of IRC 3121(a)(5)(D); and

C. any elective deferral of compensation by an individual under an eligible deferred compensation plan [as defined in IRC 457(b)] of an eligible employer described in section 457(e)(1)(A) [a State, political subdivision of a State, and any agency or instrumentality of a State or political subdivision of a State].

D. NOTE – in the case of elective deferrals described in subparagraphs A and B hereof, there is one limit for each taxpayer, not a separate limit for each plan.[29] Thus, if a taxpayer participated in both an IRC 401(k) plan and an IRC 403(b) plan, that taxpayer would have to coordinate the elective deferrals between each plan, so as not to exceed the elective deferral dollar limit of $19,000 (2019 amount, adjusted for inflation). See subsection 4.3 for a more detailed explanation.

E. NOTE - Prior to 2002, the elective deferrals of a participant in an IRC 457(b) plan were to be coordinated with amounts excluded from income under an IRC 401(k) plan, an IRC 403(b) plan, and a Simplified Employee Pension ("SEP") under IRC 408(k). Thus, contributions to other plans reduced the amount that could be deferred under an IRC 457(b) plan on a dollar for dollar basis. Today, participants in IRC 457(b) plans are no longer required to reduce their deferrals under the IRC 457(b) plan on a dollar-for-dollar basis by elective deferrals under an IRC 401(k) plan.[30]

4.2.2. The term "applicable retirement plan"[31] means:

A. an employees' trust described in IRC 401(a) which is exempt from tax under IRC 501(a) [NOTE – a profit sharing plan that includes a qualified cash or deferred arrangement is included within this definition];

B. a plan under which amounts are contributed by an individual's employer for an annuity contract described in IRC 403(b); and

C. an eligible deferred compensation plan (as defined in IRC 457(b)) of an eligible employer described in IRC 457(e)(1)(A) [a State, political subdivision of a State, and any agency or instrumentality of a State or political subdivision of a State].

4.3. <u>DRA contribution limits</u>. The following discussion for each of the three plan types that allow designated Roth contributions applies only to the amount that may be contributed by the participant to his or her DRA via elective deferral. The annual dollar limit on elective deferrals, as adjusted for inflation, in 2019 is $19,000. Under the tax rules applicable to the affected plan, a participant's elective deferrals that are treated as designated Roth contributions may also have to be considered for other purposes, such as the IRC 415(c) annual additions limit in the case of a 401(k) plan and a 403(b) plan.[32] In the case of a governmental IRC 457(b) plan, the only limit that applies is the deferral limit; i.e., there is no IRC 415(c) limit to consider.[33] All of the plans under consideration here [IRC 401(k), IRC 403(b), and governmental IRC 457(b)] may offer catch-up contributions ($6,000 for 2019) to eligible employees age 50 and older.[34]

4.3.1. <u>IRC 401(k) plans</u>. Designated Roth contributions are treated as elective deferrals for purposes of the annual dollar limit.[35]

4.3.2. <u>IRC 403(b) plans</u>. A 403(b) contract must satisfy IRC 401(a)(30) (relating to limitations on elective deferrals). A contract does not satisfy IRC 401(a)(30) unless the contract requires that all elective deferrals for an employee not exceed the limits of IRC 402(g)(1), including elective deferrals for the employee under the contract and any other elective deferrals under the plan under which the contract is purchased and under all other plans, contracts, or arrangements of the employer.[36] As is the case with IRC 401(k) plans, designated Roth contributions are treated as elective deferrals for purposes of the annual dollar limit.

4.3.3. <u>Governmental IRC 457(b) plans</u>. Generally, an IRC 457(b) plan's annual contributions and other additions (excluding earnings) to a participant's account cannot exceed the lesser of: (i) 100% of the participant's includible compensation; or (ii) the elective deferral limit ($19,000 in 2019). This limit includes the amount of employer contributions and employee deferrals.[37] The aforementioned limit is increased by the amount of catch-up contributions for participants age 50 and older.[38] There is also a special section 457(b) catch-up contributions rule, if permitted by the plan, that allows a participant for three years prior to the normal retirement age (as specified in the plan) to contribute the lesser of: (i) twice the annual limit $38,000 in 2019 and $37,000 in 2018; or (ii) the basic annual limit plus the amount of the basic limit not used in prior years (only allowed if not using age 50 or over catch-up contributions).[39]

4.4. Limited rollover options from a DRA. While not germane to the discussion of the mega Roth IRA and mega backdoor Roth IRA techniques, it is important to note for overall tax planning purposes that the monies housed in a DRA have restricted rollover options. Specifically, a rollover contribution of any payment or distribution from a DRA may be made only if the contribution is to: (i) another DRA of the individual from whose account the payment or distribution was made; or (ii) a Roth IRA of such individual.[40] Any such rollover contribution is not taken into account for purposes of determining the amount that a participant may contribute to his or her DRA.[41]

4.5. In-plan rollovers within plans that have a QRCP. In addition, certain in-plan rollovers from non-Roth accounts are now permitted to be made into a DRA of a plan that has the QRCP feature.

4.5.1. In the case of an applicable retirement plan which includes a QRCP, a distribution may be made from an account under such plan other than from a DRA, which distribution may be contributed in a qualified rollover contribution [within the meaning of IRC 408A(e)] to the designated Roth account maintained under such plan for the benefit of the individual to whom the distribution is made.[42]

4.5.2. The term "applicable retirement plan" means: (i) an employees' trust described in IRC 401(a) which is exempt from tax under IRC 501(a); (ii) a plan under which amounts are contributed by an individual's employer for an annuity contract described in IRC 403(b); and (iii) an eligible deferred compensation plan, as defined in IRC 457(b) of a governmental employer.[43]

4.5.3. In the case of any distribution from a non-Roth account to a DRA in a qualified rollover contribution, the participant includes in gross income any amount which would be includible were it not part of a qualified rollover contribution and IRC 72(t) [the 10% additional tax on early distributions from qualified retirement plans] does not apply.[44]

V. Mega backdoor Roth IRA technique

5.1. Description of the technique. The mega backdoor Roth IRA technique involves using an IRC 401(k) plan and/or IRC 403(b) plan that allow employee after-tax employee contributions in order to accumulate employee after-tax contributions in a non-Roth account for a later in-plan rollover (as described in subsection 4.5) to the affected plan's DRA or to an outside Roth IRA. The reference in this section V to "employee after-tax contributions" means an employee after-tax contribution that is not a Roth contribution.

5.2. Accumulation phase - the employee after-tax contribution rules. In this subsection, we examine the rules that affect the amount the taxpayer who is a participant in an IRC 401(k) plan and/or an IRC 403(b) plan that allow employee after-tax contributions may accumulate.

5.2.1. 401(k) plan rules for employee after-tax accounts. An IRC 40(k) plan that offers employee after-tax and/or employer matching contributions must satisfy the nondiscrimination requirements of IRC 401(a)(4) by meeting the matching and employee contributions requirements of IRC 401(m).[45] Please refer to paragraph 5.2.4 for a discussion of the IRC 401(m) test.

5.2.2. 403(b) plan rules for employee after-tax accounts. An IRC 403(b) plan may, but does not have to, allow for employee after-tax contributions to be made.[46] Employee after-tax contributions to an IRC 403(b) plan are subject to the same nondiscrimination rules that apply to after-tax contributions to qualified plans.[47] For nongovernmental IRC 403(b) plans, employee after-tax contributions and employer matching contributions are subject to the IRC 410(b) coverage test and the actual contribution percentage ("ACP") test under IRC 401(m) [see paragraph 5.2.4]. Governmental IRC 403(b) plans are deemed to satisfy the coverage test and the ACP test for employee after-tax and employer matching contributions.

5.2.3. Employee after-tax accounts not allowed under governmental IRC 457(b) plans. A governmental IRC 457(b) plan will not work as an accumulator for the mega backdoor Roth IRA technique because it cannot offer the ability for an employee to make after-tax non-Roth contributions. The only non-Roth contributions that may be made by the employee under such a plan are pre-tax salary deferral contributions, as described in 26 C.F.R. 1.457-4(a). Under that regulation, an employee's annual deferrals that satisfy the requirements of a salary deferral contribution for a governmental IRC 457(b) plan are excluded from the gross income of a participant in the year deferred or contributed and are not includible in gross income until paid to the participant. It should be affirmed here that a governmental IRC 457(b) plan may offer an elective deferral option that is treated as a Roth contribution.[48]

5.2.4. The IRC 401(m) limits that apply to employee after-tax contributions. As noted above, only IRC 401(k) and IRC 403(b) plans may offer their participants the ability to make after-tax employee contributions. The nondiscrimination test described in IRC 401(m), a/k/a the ACP test, compares the ratio of percentages of employee after-tax contributions and employer matching contributions for the group of highly compensated employees with such percentages for the group of nonhighly compensated employees and tests them for nondiscrimination. The nondiscrimination test under IRC 401(m) is passed if the contribution percentage for the group of eligible highly compensated employees for such plan year does not exceed the greater of: (i) 25% of such percentage for all other eligible employees for the preceding plan year; or (ii) the lesser of 200% of such percentage for all other eligible employees for the preceding plan year, or such percentage for all other eligible employees for the preceding plan year plus two percentage points.

5.2.5. Effect of the IRC 401(m) limits on the taxpayer's ability to accumulate funds for Roth conversion. There is no rule of thumb for the amount of employee after-tax contributions that a highly compensated employee may contribute to his or her IRC 401(k) and/or IRC 403(b) plan because of the vagaries of the IRC 401(m) nondiscrimination test. Each year, the applicable plan must be tested for nondiscrimination under IRC 401(m). The plan administrator [ERISA 3(16)] will inform the highly compensated employees of the amount of employee after-tax contributions they may make.

5.2.6. Effect of the IRC 415(c) limits on the taxpayer's ability to accumulate funds for Roth conversion. Another IRC limit that affects an employee's ability to accumulate funds in an after-tax account under the plan is IRC 415(c), which is often referred to as the "annual additions limit." Under IRC 415(c)(1), contributions and other additions with respect to a participant may not exceed the lesser of: (i) an inflation-adjusted dollar amount [$56,000 for 2019]; or (ii) 100% of the participant's compensation. Under IRC 415(c)(2), the term "annual addition" means the sum for any year of: (i) employer contributions; (ii) employee contributions; and (iii) forfeitures. The employee contribution amount is determined without regard to rollovers.

5.2.7. Summary of all the limits that apply to the taxpayer seeking to utilize the mega backdoor Roth IRA technique.

A. DRA account limits. The taxpayer should should first avail himself or herself of all available Roth elective deferral contributions, within the limits described in subsection 4.3. Please reference the discussion in paragraph 4.2.1 of which elective deferrals must coordinated to stay within the overall dollar limit.

B. IRC 401(m) test for after-tax employee contributions. Next, the taxpayer who is a participant in an IRC 401(k) plan or IRC 403(b) plan that allows for employee after-tax contributions may contribute to the after-tax account in the affected plan, up to the limits permitted by satisfaction of the IRC 401(m) test, as conducted by the plan administrator [ERISA 3(16)].

C. IRC 415(c) annual additions limit. The annual additions limit, as explained in paragraph 5.2.6, serves as an overall limit that the taxpayer must consider when determining his or her ability to fund an after-tax account in an IRC 401(k) or IRC 403(b) plan as an accumulator for later conversion to a DRA or distribution to a Roth IRA.

5.3. Conversion phase – the employee after-tax contributions. The discussion in subsection 5.2 centered on accumulating funds for later conversion to a DRA or rollover to a Roth IRA. This subsection focuses on that process.

5.3.1. Conversion via in-plan rollover to DRA. The legal authority for the discussion in this paragraph is IRS Notice 2013-74, which contains guidance on rollovers within a retirement plan to designated Roth accounts in the same plan, known as in-plan Roth rollovers. The new rules relate to the expansion of these rollovers under new IRC 402A(c)(4)(E), as added by the American Taxpayer Relief Act of 2012 (P.L. 112-240).

A. IRC 402A(c)(4)(E) provides that a plan with a DRA can permit an in-plan Roth rollover of an amount not otherwise distributable under the plan. Thus, the following contributions (and earnings thereon) may now be rolled over to a DRA in the same plan, without regard to whether the amounts satisfy the conditions for distribution: (i) elective deferrals in IRC 401(k) plans and IRC 403(b) plans; (ii) matching contributions and nonelective contributions, including qualified matching contributions and qualified nonelective contributions described in 26 C.F.R. 1.401(k)-

6; and (iii) annual deferrals made to governmental IRC 457(b) plans. The federal government's Thrift Savings Plan is treated as an IRC 401(k) plan for this purpose.

B. If an amount is rolled over to a DRA pursuant to IRC 402A(c)(4)(E), then, notwithstanding Revenue Ruling 2004-12, the amount rolled over and applicable earnings remain subject to the distribution restrictions that were applicable to the amount before the in-plan Roth rollover. Thus, for example, if an IRC 401(k) plan participant who has not had a severance from employment makes an in-plan Roth rollover of an amount from the participant's pre-tax elective deferral account prior to age 59 ½, that amount and applicable earnings may not be distributed from the plan prior to attainment of age 59 ½ or the occurrence of another event described in IRC 401(k)(2)(B) [see subparagraph 5.3.2.A].

C. No withholding under IRC 3405 applies to an in-plan Roth rollover.

5.3.2. Rollovers out of an IRC 401(k) plan to a Roth IRA. The first consideration in the case of a rollover distribution from an IRC 401(k) plan to a Roth IRA is that the amount being rolled over must be done pursuant to a distributable event from the IRC 401(k) plan.

A. The discussion in this paragraph presumes that the distribution being made is attributable to a participant's employee after-tax contributions account that are not subject to the distribution restrictions applied to a participant's elective deferral account.[49] Distributions from a participant's elective deferral account may not be made unless the participant has: (i) had a severance from employment; (ii) died; (iii) become disabled; or (iv) attained age 59 ½.[50]

B. Distributions from a participant's employee after-tax contributions account may be made in accordance with the long-standing IRS rules for distributions from a profit-sharing plan. A profit-sharing plan may provide for distribution of funds accumulated under a plan after a fixed number of years (but no fewer than two), the attainment of a stated age, or on the prior occurrence of some event such as layoff, illness, disability, retirement, death, or severance of employment.[51] The IRS has also ruled that a profit-sharing plan may permit participants with at least five years of participation to withdraw all employer contributions, including those made in the last two years.[52]

C. Assuming that the affected participant has satisfied the applicable distributable event criteria, as set forth in the plan under consideration, then the rollover to the Roth IRA can be made either by direct rollover from the plan to the Roth IRA or can be effected by distribution from the plan to the participant who will roll the amount distributed into the Roth IRA within 60 days (i.e., the "60-day rollover").

D. The amount being rolled over must constitute an "eligible rollover distribution" from the IRC 401(k) plan.[53] An "eligible rollover distribution" means any distribution to an employee of all or any portion of the balance to the credit of the employee in a qualified trust; except that such term shall not include: (i) any distribution which is one of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of the employee and the employee's designated beneficiary, or for a specified period of 10 years or more; (ii) any distribution to the extent such distribution is required under IRC 401(a)(9); and (iii) any distribution which is made upon hardship of the employee.[54]

5.3.3. Rollovers out of an IRC 403(b) contract to a Roth IRA. As in the case of a distribution from an IRC 401(k) plan, it is also necessary to consider the source of the distribution from the IRC 403(b) contract when doing a rollover into a Roth IRA. The term "IRC 403(b) contract" includes an annuity contract under IRC 403(b)(1), a custodial account under IRC 403(b)(7), and a retirement income account under IRC 403(b)(9).

A. In the case of an IRC 403(b) contract, contributions made pursuant to a salary reduction agreement (i.e., elective deferrals) may be paid only when the employee attains age 59 ½, has a severance from employment, dies, or becomes disabled (within the meaning of IRC 72(m)(7)). Hardship distributions are also permitted, but no income may distributed in that distribution.[55]

B. Since employee after-tax contributions are not subject to the distribution restrictions that apply to elective deferrals made to an IRC 403(b) contract, their distribution can be made at the election of the owner of the IRC 403(b) contract and subject to the requirements of the IRC 403(b) plan document.

C. In order to be rolled over to a Roth IRA, the distribution must constitute an "eligible rollover distribution," as described in sub-paragraph 5.3.2.D.

5.3.4. Rollovers out a governmental IRC 457(b) plan to a Roth IRA. Because a governmental IRC 457(b) plan does not accommodate employee after-tax contributions [see paragraph 5.2.3], it is not used as an accumulator of funds for subsequent distribution to a Roth IRA as part of the mega backdoor Roth IRA technique.

5.3.5. Withholding on rollovers out of an IRC 401(k) plan or an IRC 403(b) plan to a Roth IRA. The payor of an eligible rollover distribution is required to withhold 20% of such amount.[56] No withholding is required on an eligible rollover distribution if there is a direct rollover to an eligible retirement plan.[57] An "eligible rollover distribution" for purposes of the income tax withholding requirements has the meaning given it in IRC 402(f)(2)(A).[58] Distributions from both IRC 401(k) plans and IRC 403(b) plans are encompassed within IRC 402(f)(2)(A).

5.4. Reporting of the rollover transaction,

5.4.1. Reports required of the distributing IRC 401(k) plan or IRC 403(b) plan. The instructions to IRS Form 1099-R state that the payor of a distribution from either of these plans is to report the distribution to the IRS using Form 1099-R, with a copy thereof to the affected taxpayer.

5.4.2. Taxpayer reporting of the rollover transaction on Form 1040. The instructions to IRS Form 1040 (for use in preparing 2018 returns) state the following regarding rollovers:

"Generally, a rollover is a tax-free distribution of cash or other assets from one retirement plan that is contributed to another plan within 60 days of receiving the distribution. However, a rollover to a Roth IRA or a designated Roth account is generally not a tax-free distribution. Use lines 4a and 4b to report a rollover, including a direct rollover, from one qualified employer's plan to another or to an IRA or SEP. Enter on line 4a the distribution from Form 1099-R, box 1. From this amount, subtract any contributions (usually shown in box 5) that were taxable to you when made. From that result, subtract the amount of the rollover. Enter the remaining amount on line 4b. If the remaining amount is zero and you have no other distribution to report on line 4b, enter -0- on line 4b. Also, enter 'Rollover' next to line 4b."

VI. Concluding thoughts

6.1. This paper has not attempted to answer the question whether a Roth IRA contribution or rollover is appropriate or not for any given taxpayer. The assumption was that such planning has already been done.

6.2. Many taxpayers for whom an annual Roth IRA contribution makes sense are not able to take advantage of it due their AGI being too high. Alternatively, other taxpayers may feel restrained by the relatively modest dollar limit that applies to annual Roth IRA contributions. It is for these taxpayers that the backdoor Roth IRA and the mega backdoor Roth IRA techniques are intended.

6.3. The backdoor Roth IRA technique involves an annual nondeductible contribution made to a traditional IRA that is, within the same tax year in which it was made, converted to a Roth IRA. Even though the nondeductible contribution made to the traditional IRA and the nondeductible contribution made to the Roth IRA leave the taxpayer who made them in the same tax position at the time the contributions were made, the Roth IRA has two significant advantages on the distribution end that militate in favor of doing the Roth IRA conversion. Specifically, a qualified distribution from a Roth IRA is tax-free, both as to principal and earnings, whereas the distribution from a traditional IRA of nondeductible contributions is subject to the aggregation and pro rata rules discussed in subsection 3.4. The other advantage of a Roth IRA over a traditional IRA funded with nondeductible contributions is that the IRC 401(a)(9) rule on minimum required distributions does not apply to the Roth IRA during the life of the participant/owner.

6.4. If the taxpayer is a participant in a plan of his or her employer that includes the opportunity to make elective deferral contributions into a DRA, he or she may wish to take advantage of that opportunity. Plans that can make that optional feature part of their plan document include IRC 401(k), IRC 403(b), and IRC governmental 457(b). An additional opportunity for a participant in a plan that includes a DRA may be an in-plan rollover from another account in the same plan to the DRA.

6.5. A final method that a participant in an IRC 401(k) plan and/or an IRC 403(b) plan that includes an employee after-tax contribution capability to accumulate funds for subsequent rollover to a Roth IRA is the so-called mega backdoor Roth IRA. That method involves accumulating nondeductible employee contributions in the affected plan and later rolling them into a Roth IRA.

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[1] IRC 408A(c)(2)(A). This amount is determined without regard to the rule regarding nondeductibility of contributions for individuals over age 70 ½ or the AGI phase-out for active participants in an employer-sponsored retirement plan, because IRC 408A(c)(2)(A) provides that the maximum amount is computed without regard to IRC 219(d)(1) or IRC 219(g).
[2] Contributions to SEPs or SIMPLE IRAs are not taken into account for this purpose. IRC 408A(f)(2).
[3] IRS Publication 590-A (2018).
[4] IRC 408A(c)(6) and IRC 408A(e).
[5] IRS Publication 590-A (2018).
[6] *Id*. Contribution amounts adjusted for 2019 cost-of-living figures, per IRS Notice 2018-83.
[7] IRS Publication 590-A (2018).
[8] IRS Publication 590-B (2017).
[9] See the discussion of the IRA aggregation rule in subsection 3.4.
[10] IRS Publication 590-A(2018). Contribution amounts adjusted for 2019 cost-of-living figures, per IRS Notice 2018-83.
[11] *Id*. Contribution amounts adjusted for 2019 cost-of-living figures, per IRS Notice 2018-83.
[12] *Id*. Contribution amounts adjusted for 2019 cost-of-living figures, per IRS Notice 2018-83.
[13] IRC 408A(d)(2).
[14] Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA") sec. 512. (H. R. 4297, Pub. L. No. 109-222).
[15] Temp. Treas. Regs. sec. 1.401(a)(5)-1T, Q&A-3.
[16] IRC 408A(e)(1)(B) and IRC 402(c)(8)(B)(iii)-(vi).
[17] IRC 408A(d)(3)(A)(i).
[18] IRS Publication 590-A, page 20.
[19] Michael Kitces. *How To Do A backdoor Roth IRA (Safely) And Avoid the IRA Aggregation Rule and Step Transaction Doctrine*. Blog post dated August 12, 2015 on www.kitces.com.
[20] *Commissioner v. Clark*, 489 U.S. 726, 738 (1989).
[21] P.L. 115-97; December 22, 2017.
[22] Conference Report, P.L. 115-97, page 637.
[23] *Id*.
[24] Conference Report, P.L. 115-97, page 639.
[25] *Id*.
[26] IRC 402A(b)(1).
[27] IRC 402A(b)(2).
[28] IRC 402A(e)(2).
[29] 26 C.F.R. 1.402(g)-1(b).
[30] IRC 457(c), as amended by P.L. 107-16 (Economic Growth and Tax Relief Reconciliation Act of 2001), Act Sec. 615(a). Note that as originally enacted, this provision was subject to sunset after 2010 (see EGTRRA Sec. 901). The provision was made permanent by P.L. 109-280 (Pension Protection Act of 2006), Act Sec. 811.
[31] IRC 402A(e)(1)(A), (B), (C).
[32] 26 C.F.R. 1.415(c)-1(b).
[33] 26 C.F.R. 1.415(c)-1(a)(2).
[34] 26 C.F.R. 1.414(v)-1(g).
[35] IRC 402A(c)(2) and 26 C.F.R. 1.402(g)-1(b)(5).
[36] 26 C.F.R. 1.403(b)-3(a)(4).
[37] 26 C.F.R. 1.457-4(c)(1).
[38] 26 C.F.R. 1.457-4(c)(2).
[39] 26 C.F.R. 1.457-4(c)(3).
[40] IRC 402A(c)(3)(A).
[41] IRC 402A(c)(3)(B).
[42] IRC 402A(c)(4)(B).
[43] IRC 402A(e)(1)(A), (B), (C).
[44] IRC 402A(c)(4).
[45] 26 C.F.R. 1.401(m)-1(a)(1).
[46] 26 C.F.R. 1.403(b)-4(b)(1).
[47] 26 C.F.R. 1.403(b)-5(a).
[48] IRC 402A(e)(2)(B).
[49] IRC 401(k)(2)(B).
[50] IRC 401(k)(2)(B).
[51] Rev. Rul. 71-295.
[52] Rev. Rul. 68-24.
[53] IRC 402(c)(4).

[54] *Id.*
[55] IRC 403(b)(11).
[56] IRC 3405(c)(1).
[57] IRC 3405(c)(2).
[58] IRC 3405(c)(3).