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It's Not About Timing: IRS on Backdoor Roth Conversions

The IRS has weighed in – tersely – on immediate backdoor Roth conversions, but that may not put to rest the controversy kicked up by a recent *Financial Planning* article on the strategy.

Many planners use these conversions regularly because they are a boon for high-income clients. IRS phaseouts fully disqualify clients with high, adjusted gross incomes from making direct contributions to Roths. For single tax filers the income phaseout threshold is $131,000 for 2015; for married couples filing jointly it's $193,000.

Backdoor Roth conversions give those clients who earn too much money a workaround, allowing them to make nondeductible $5,000 contributions (or $6,000 nondeductible catch-up contributions for those over 50) annually into Roths by first putting the money into IRAs and then converting to Roths.

The controversy about conversions centers not on the conversions themselves, but on their timing.

Financial Planning contributing writer Michael Kitces maintains that planners who do them right away – shuttling IRA money into a Roth without a waiting period – run the risk of incurring the IRS' wrath.

IRS: 'NO CAVEAT ABOUT WAITING'

The IRS guidance on the matter, however, would seem to allay those concerns.

"There's no caveat about waiting," the IRS says in an email via its spokesman Dean Patterson.

That guidance doesn't comfort Kitces.

"The IRS can only answer [from] the tax code -- there is no Congress-mandated time limit -- and they can't answer to how a tax court would interpret the situation," Kitces wrote via email.

That's the rub, in Kitces' view.

He tweeted out his strongly worded concerns about immediate conversions after Ray Edwards, a CPA and the director of tax services at the large RIA Aspiriant, urged planners to do same-day conversions in a recent *Financial Planning* webinar and, again, in the follow-up article.

Doing same-day conversions eliminates the risk that clients could incur taxable liabilities in the case when the value of the IRA holdings were to rise before the conversion takes place, Edwards says.

However, Kitces believes, doing immediate conversions also could cause clients to run afoul of a judicial principle called the "step transaction doctrine."

"The step transaction doctrine," Kitces wrote in an earlier blog post on the subject, "is the legal principle that a series of related steps in a transaction should be taxed based on the overall economic nature of the transaction, not 'just' based on the separate individual steps."

TAX COURT RISK?

The step transaction doctrine could be invoked against a client if and when his or her dispute with the government ends up in tax court, he says.

To protect against this prospect some planners wait before converting. Jeff Yamada, chief compliance officer of MCS Family Wealth in Eugene, Ore., says he waits for months between making IRA contributions before the April 15 tax deadline and doing conversions in the fall before the Oct. 15 extension deadline. "We have been concerned about the practice," Yamada says.

In his own practice, Kitces says, he waits a full year between the two transactions.

"This puts a pretty healthy waiting period between the contribution and subsequent conversion [and] provides opportunity for someone's situation and circumstances to change," Kitces says, "which is the whole point. That's what affirms these were separate transactions, and not a single whole."

Edwards, along with many other planners, thinks this is unnecessary.

"The idea that people are somehow getting an unintended benefit [from immediate conversions] is just not the case," Edwards says of concerns over the strategy. "The White House has encouraged everyone at every level to provide for their own retirement."

A CAUTIONARY NOTE

The IRS declined to specifically respond to a question regarding the step transaction doctrine, while adding a cautionary note.

"Please be careful," Patterson advised. "Every taxpayer has a unique set of facts and circumstances. And, also, the various companies that offer IRAs may have their own rules on conversions."

One precondition to doing conversions on which the IRS and all planners agree upon is the following: Only clients who have already converted all their previous IRAs to Roths – an important and frequently overlooked precondition -- can take full advantage of the strategy.

Fore more information, Patterson referred planners to the following IRS publication about the strategy.

Many planners say they've done immediate backdoor conversions without fear of repercussions ever since the tax law changed in 2010 to allow them.

"That's a myth," says planner Allan Roth, also a *Financial Planning* contributing writer and founder of Wealth Logic in Colorado Springs, Colo., of concerns that immediate conversions will trigger heightened IRS scrutiny. "The only thing that could backfire would be if Congress changes laws, but if Congress doesn't change laws, you can have all that growth tax free."

Roth says he doesn't anticipate this will happen given that the dollar amounts taxpayers can contribute to Roths are not very high.

'WHY DELAY?'

"We do immediate conversions. Why delay?" asks Kevin Reardon, president of Shakespeare Wealth Management in Pewaukee, Wis. "The sooner we can get money growing tax free, the better. If the markets go down, we can always recharacterize."

That's an important point.

One helpful attribute of Roth contributions, including backdoor ones, is that clients can reverse them by shuttling them back into another IRA for any reason, including if they were done incorrectly or if market fluctuations wipe out the value of the strategy in a given tax year. The recharacterization can occur anytime during the year after the Roth conversion, but no later than that Oct. 15. That gives planners and their clients a big cushion of time in which to reconsider their use of the strategy.

'I WON'T MAKE THAT MISTAKE AGAIN'

Most people who run into problems doing the conversions, simply do them incorrectly by failing to follow the IRS' rules, many planners say.

Jerry Verseput, founder of Veripax Financial Management in El Dorado Hills, Calif., says he recently told a prospective client that he couldn't take advantage of the backdoor Roth conversion because of his large traditional IRA. Remember: all IRAs must already have been converted to Roths for the backdoor strategy to work.

"They informed me that their current advisor has been doing the backdoor conversions by creating a separate IRA account," Verseput says. "[I]f the IRS catches this, the investor is headed for a multi-year penalty."

One of Michael Kalscheur's clients also did a backdoor conversion, while still holding traditional IRA assets. Kalscheur is a senior financial consultant with Castle Wealth Advisors in Indianapolis.

"Luckily we were able to get it fixed in time" with a recharacterization, he says, "but I won't make that mistake again."

CONVERSION CHALLENGED

The IRS sent one of Marty McNamara's clients a worrisome letter triggered by a Roth conversion that could have produced an additional tax plus interest and penalties, he says. The client prepares his own tax returns, he adds.

The client's 1099-R forms showed the Roth conversion amount, McNamara says, while another form, Form 5498, showed the IRA contribution amount. Custodians automatically provide both forms to the client and to the IRS. Those two amounts had to match and they did, McNamara said, but the client failed to inform the IRS that he had no other IRAs.

"After some coaching on my end," McNamara, a CPA and the cofounder of Marrick Wealth in Irvine, Calif., says, "my client was able to respond to the IRS with a letter explaining the nondeductible IRA contribution and subsequent Roth conversion. He also included a copy of the 1099-R and Form 5498, explaining the basis in his IRA was equal to the conversion amount and that he had no other IRA balances, so the conversion was non-taxable. The IRS responded with a letter explaining [that] no further action or taxes [were] required based on the information provided. Of course, we were both pleased with the outcome."

'THERE SHOULD NOT BE PROBLEMS'

Jim Oliver, a CPA and founder of Financial Life Advisors in San Antonio, Texas, thinks many clients and planners run into problems doing conversions because the process is technical, complicated and requires time to understand and master.

"The tax form is not intuitive," Oliver says, "the instructions can be confusing and tax software not easy to code to get the right amounts on the right lines."

But it's worth taking the time to learn how do them correctly, he thinks.

"From all the research we've done," he says, "if all is done correctly, there should not be problems with the IRS."

Read more:

- 5 Tips for Backdoor Roth Conversions
- Kitces: When Not to Convert to a Roth
- IRA Rollover Goofs to Avoid
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