Pennies and the Backdoor Roth IRA

In personal finance and the rest of life "there are no dumb questions" and I will try to cheerfully answer every question I'm given. I have certainly asked lots of questions that in retrospect seem dumb. But I'm getting sick of answering this one about Backdoor Roth IRAs. (If you have no idea what a Backdoor Roth IRA is, read this post first. Seriously. You need to know what it is. If you like, you can read the 941+ comments below the post where you will see variations of this question asked dozens of times.)

At any rate, I decided I was going to write a blog post about it so I could just link to the post instead of typing out the answer over and over again in comments, the forum, and emails. If I sent you a link to this post in response to your question, please don't take personal offense. I don't think you're dumb, but it's way easier for me to post a link to a comprehensive answer to this question than to type all this out every time.

Questions I Always Get Asked About the Backdoor Roth IRA

How to Account for the Pennies in Interest

Q.

I just did the Backdoor Roth IRA for the first time and was appalled to find out that over the three days I had that $5,500 in a money market fund in the traditional IRA before conversion it earned 37 cents in interest. Now I'm afraid the IRS is going to come after me and repossess my dog. What should I do to keep the IRS at bay?

A.

These are questions that don't get asked by people who have done their own taxes for years. The reason why is they know you don't report cents on your taxes. You just round down or up. So if you do a Roth conversion of $5,500.37, all the IRS knows (and cares about) is that you converted $5,500. Seriously. Nobody cares about that 37 cents. You just got a free 37 cent Roth conversion!

Q.

But that 37 cents is actually still in the traditional IRA! I didn’t actually convert it.

A.

Great. Leave it there until next year. Then convert it with your next $5,500. It’ll still be free since it isn’t going to grow to 50 cents in a money market fund in one year.

Q.

Unfortunately, it turns out it wasn’t 37 cents. It was 87 cents. Now what?

A.

You now have a taxable transaction, since you will round that up to $1.00. You will owe taxes on it. That could be as much as 45-50 cents added to your tax bill! Here’s how you report it:

1	Enter your nondeductible contributions to traditional IRAs for 2016, including those made for 2016 from January 1, 2017, through April 18, 2017 (see instructions)	1	5500
2	Enter your total basis in traditional IRAs (see instructions)	2	0
3	Add lines 1 and 2	3	5500
	In 2016, did you take a distribution from traditional, SEP, or SIMPLE IRAs, or make a Roth IRA conversion? — No → Enter the amount from line 3 on line 14. Do not complete the rest of Part I. — Yes → Go to line 4.		
4	Enter those contributions included on line 1 that were made from January 1, 2017, through April 18, 2017	4	0
5	Subtract line 4 from line 3	5	5500
6	Enter the value of **all** your traditional, SEP, and SIMPLE IRAs as of December 31, 2016, plus any outstanding rollovers (see instructions)	6	0
7	Enter your distributions from traditional, SEP, and SIMPLE IRAs in 2016. **Do not** include rollovers, qualified charitable distributions, a one-time distribution to fund an HSA, conversions to a Roth IRA, certain returned contributions, or recharacterizations of traditional IRA contributions (see instructions)	7	0
8	Enter the net amount you converted from traditional, SEP, and SIMPLE IRAs to Roth IRAs in 2016. **Do not** include amounts converted that you later recharacterized (see instructions). Also enter this amount on line 16	8	5501
9	Add lines 6, 7, and 8	9	5501
10	Divide line 5 by line 9. Enter the result as a decimal rounded to at least 3 places. If the result is 1.000 or more, enter "1.000"	10	× 0 . 999
11	Multiply line 8 by line 10. This is the nontaxable portion of the amount you converted to Roth IRAs. Also enter this amount on line 17	11	5500
12	Multiply line 7 by line 10. This is the nontaxable portion of your distributions that you did not convert to a Roth IRA	12	0
13	Add lines 11 and 12. This is the nontaxable portion of all your distributions	13	5500
14	Subtract line 13 from line 3. This is **your total basis in traditional IRAs for 2016 and earlier years**	14	0
15	**Taxable amount.** Subtract line 12 from line 7. If more than zero, also include this amount on Form 1040, line 15b; Form 1040A, line 11b; or Form 1040NR, line 16b	15	0
	Note: You may be subject to an additional 10% tax on the amount on line 15 if you were under age 59½ at the time of the distribution (see instructions).		

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Part II **2016 Conversions From Traditional, SEP, or SIMPLE IRAs to Roth IRAs**

Complete this part if you converted part or all of your traditional, SEP, and SIMPLE IRAs to a Roth IRA in 2016 (excluding any portion you recharacterized).

16	If you completed Part I, enter the amount from line 8. Otherwise, enter the net amount you converted from traditional, SEP, and SIMPLE IRAs to Roth IRAs in 2016. **Do not** include amounts you later recharacterized back to traditional, SEP, or SIMPLE IRAs in 2016 or 2017 (see instructions)	16	5501
17	If you completed Part I, enter the amount from line 11. Otherwise, enter your basis in the amount on line 16 (see instructions)	17	5500
18	**Taxable amount.** Subtract line 17 from line 16. If more than zero, also include this amount on Form 1040, line 15b; Form 1040A, line 11b; or Form 1040NR, line 16b	18	1

Easy peasy, right? By the way, if your tax preparer doesn't know what to do with it, send him a link to this post. (Dear tax preparer, please don't be offended if you were sent this link. I know the vast majority of your clients don't do Backdoor Roth IRAs.)

Opening A "Business" To Get An Individual

401(k) For A Rollover

Here's another little trick a lot of people may not know about. Some people don't want to do a Backdoor Roth IRA due to the pro-rata issue. This trick doesn't work so well if you have a business where each year you are making SIMPLE IRA or SEP IRA contributions. But it does work very well if the only reason you aren't doing a Backdoor Roth IRA is because you have a big fat SEP-IRA, rollover IRA, or traditional IRA that you are no longer making contributions to. (See line 6 of the 8606 above- you want it to be zero if you're doing the Backdoor Roth IRA.) There is always the option to just convert that tax-deferred IRA and pay the taxes on it, but if it is really large, that's probably not a good idea. So what can you do? You can start a business.

Step 1: Get an Employer Identification Number (EIN). It only takes five minutes and is free. You don't need an LLC or an S Corp or even a name separate from your own.

Step 2: Make some money. Doesn't have to be much. $10 is fine, but even better if it is enough money that someone gives you a 1099 ($600+). Babysit someone's kid. Mow your neighbor's lawn. Shovel a driveway. Do an online survey. Whatever. Make some money. Report it on Schedule C (lines 1, 5, 7, and 31) at the end of the year. Don't forget Schedule SE too. Congratulations! You're now self-employed! That wasn't so hard, was it?

Step 3: Open an individual 401(k) at Fidelity or eTrade (the Vanguard individual 401(k) doesn't take rollovers). You can contribute 20% of your $10-600 if you like (report it on Form 1040, line 28), but it's not required.

Step 4: Roll that pesky IRA over to the individual 401(k) before December 31st.

Step 5: Do the Backdoor Roth IRA as usual. (Contribute $5,500 to a traditional IRA, then convert it tax-free into a Roth IRA.)

Voila! You can now invest $5,500 a year ($11K a year if you do it for your spouse too) in a tax-free and (probably) asset protected account instead of your regular old taxable account.

What Does the IRS Say About Backdoor Roths?

The IRS didn't really weigh in at all about the Backdoor Roth IRA for years, leaving taxpayers and advisors wondering if the step transaction doctrine could ever be applied to it. I have yet to hear about a case where the IRS gave someone a problem (other than asked a few clarifying questions) about the Backdoor Roth IRA (please send me details if you know of one) and there certainly has not been a tax court case resolving this issue. But I found out recently that the IRS has at least said something about it, although what they said really didn't surprise me. As noted in [this article] in Financial Planning:

> *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. 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….*
>
> *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."*

I'll bet the law gets changed before this ever gets tested in tax court because after 8 cycles now, nobody in Congress nor the IRS seems to really care. The only question is whether the law will change to allow high earners to make direct Roth contributions or whether the law will change to once again disallow high earners from making Roth conversions.

What do you think? Are you one of the dozens (hundreds?) of people who have had this question at one point? Do you have a pro-rata problem? Can you solve it by starting a (very small) business? Do you worry about the step transaction doctrine? Comment below!