What is a back-door Roth conversion strategy?

Are you interested in making contributions to a Roth IRA but your Modified Adjusted Gross Income (MAGI) is too high? Do you choose not to contribute to a Traditional IRA because you are covered by a workplace retirement plan (WRP) and your MAGI is at or above the phase-out limits for a deduction? If so, chances are good you've been told or read about the "back-door" Roth conversion. But what is it? At its simplest, it's a Roth conversion of after-tax amounts in a Traditional IRA, meaning you won't pay tax when converting. This strategy may not be as easy as it sounds and if you don't understand all the rules, this conversion can have negative tax consequences. The following information can help you understand the rules and the process, as well as the possible risks. Be sure to talk to your financial advisor as well as your tax advisor before initiating this strategy.

Understand the pro rata rule

You should be familiar with the pro rata rule before you take a distribution or make a conversion when you have before-tax and after-tax amounts in any Traditional, SEP, and/or SIMPLE IRA. (These three will collectively be referred to as Traditional IRA(s) in the rest of this piece.) Amounts in a Roth IRA are not subject to this rule. Traditional IRAs with after-tax amounts that you inherited as a beneficiary will also use the pro rata rule but those amounts are not included in the calculation for Traditional IRAs where you are the owner.

The pro rata rule is often referred to as the cream-in-your-coffee rule. Once the cream and coffee are combined, you cannot separate them; in the same way, blending before-tax and after-tax funds in any Traditional IRA(s) cannot be separated. This is true even if you keep the before-tax amounts in a different Traditional IRA from the after-tax amounts, as the year-end values of all Traditional IRA(s) are combined for purposes of determining the percentage of any distribution or conversion that is taxable.

What this means is that the pro rata rule prevents you from being able to distribute or convert only after-tax or before-tax amounts in your Traditional IRA. This rule is often not mentioned when a "back-door" Roth conversion strategy is discussed and is what can cause your conversion to be taxable. This taxable event may not be discovered until you file your taxes. Since you no longer have the ability to recharacterize, or undo the conversion, you will have to find a way to pay for the conversion taxes.

How you can have after-tax amounts in your IRA

The following are a few ways your Traditional IRA balance could include after-tax amounts or basis:

- Making nondeductible contributions. You are eligible to make a contribution to your Traditional IRA as long as you have earned income, or are married and file jointly. Your contribution will not be deductible if you are covered by a WRP and are at or above the MAGI limits for a deduction.

- You rolled over after-tax amounts from your qualified employer sponsored retirement plan (QRP) such as a 401k, 403b, or governmental 457b. These after-tax amounts aren't the same as amounts contributed to a designated Roth account in your QRP.
- Repaying a qualified reservist distribution. There is a two-year period after the end of active duty to repay (recontribute) the distribution to a Traditional IRA. The recontributed amount is considered "basis" in the IRA since income taxes were paid when originally distributed.

Your IRA custodian is not responsible for keeping track of any after-tax amounts you have in your Traditional IRA. Instead, you or your tax preparer will file IRS form 8606. This form is used to keep track of the basis, which is the total of all after-tax amounts in your Traditional IRA, minus the total of all your nontaxable distributions.

Ways to remove before-tax amounts

If you want to make nondeductible contributions and convert them with no tax consequence, you would need to eliminate any before-tax amounts. Review the following options that you might find appropriate for your situation:

- You could convert all of the before-tax amount, if those amounts are small and you can afford to pay the associated tax. You could also elect to convert over a few years if the before-tax amount is too much of a tax burden to convert at one time.
- Many QRPs accept direct rollovers from a Traditional IRA but only the before-tax amounts are allowed to be rolled. If you have access to a QRP, discuss this option with your QRP administrator. Remember, once you move Traditional IRA assets to the QRP, you are subject to that QRP's rule regarding distributions for you as well as your beneficiaries, investment choices, and lack of holistic advice.

Once you have ensured that you do not have any before-tax amounts in any of your own Traditional IRAs, you can make your nondeductible contribution and convert to a Roth without paying tax on that amount. It is a best practice not to invest the contribution until after you convert to the Roth IRA. You should convert soon after making the contribution to ensure there are no earnings in the Traditional IRA prior to the conversion. Any earnings would be taxable and would trigger the pro rata rule.

Keep in mind

It is important to understand that this strategy can have tax implications when you have before-tax amounts in any of your Traditional IRAs held at Wells Fargo Advisors, as well as at any other financial institution. Also remember that Roth conversions cannot not be undone or recharacterized. A Roth conversion must be completed within the calendar year and you will pay any tax due for the tax year of the conversion.

Talk with Wells Fargo Advisors

If you are thinking about a Roth conversion, we suggest you speak with your tax advisor as well as your financial advisor with Wells Fargo Advisors. They will be able to review your specific situation and discuss a Roth conversion in more detail.

With you every step of the way

Everyone has a different vision of retirement that requires a unique financial strategy. Wells Fargo Advisors can support you in your retirement planning process by providing the guidance needed to make informed choices. We will meet with you and help create a comprehensive plan that takes into account your complete financial picture. Your financial advisor will be with you every step of the way to meet to review your progress and adapt your plan as needed. Working together, we'll design and implement an investment plan that can help you live out your unique vision of retirement.

Traditional IRA distributions are taxed as ordinary income. Qualified Roth IRA distributions are not subject to state and local taxation in most states. Qualified Roth IRA distributions are also federally tax-free provided a Roth account has been open for more than five years and the owner has reached age 59½ or meets other requirements. Both may be subject to a 10% additional tax if distributions are taken prior to age 59½.