

## Chapter 8: Retirement Plan Issues for Individuals

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**Note.** Corrections were made to this workbook through January of 2024. No subsequent modifications were made. For terms used in this chapter, see the **Acronyms and Abbreviations** section following the index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

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## INHERITED RETIREMENT PLANS

The Setting Every Community Up for Retirement Enhancement (SECURE) Act<sup>1</sup> significantly changed the distribution rules related to inherited employer plans and individual retirement arrangements (IRAs) for many beneficiaries. The Act is effective for retirement plans and IRAs where the account owner dies after December 31, 2019. For taxpayers who inherited retirement plans and IRAs on or before December 31, 2019, the rules were not changed by SECURE. The Act established three tiers of beneficiaries: designated beneficiaries (DB), eligible designated beneficiaries (EDB), and nondesignated beneficiaries. EDBs include surviving spouses and certain other protected individuals, and EDBs are still able to use the prior rules relative to inherited plans during their lifetime.<sup>2</sup> This discussion focuses on the new rules that apply to DBs.

**Note.** For more information about retirement plan distributions, see the 2020 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 1: Retirement Plan Distributions. This can be found at [uofi.tax/arc](https://uofi.tax/arc) [[taxschool.illinois.edu/taxbookarchive](https://taxschool.illinois.edu/taxbookarchive)].

Prior to the SECURE Act, owners of retirement plans could use tax planning strategies such that the beneficiaries could extend taking distributions from an IRA over the longest period of time possible. These planning strategies were known as “stretch IRAs.” The stretch IRA allowed family wealth to accumulate in inherited retirement accounts. The relatively small distributions permitted by the stretch IRA generally had a limited effect on DBs’ tax planning unless their inherited IRAs were large.

The SECURE Act requires that DBs must take distributions of the entire interest in the inherited plan by the end of the 10th calendar year following the account owner’s death.<sup>3</sup> Initially, many advisors were uncertain whether the new required minimum distribution (RMD) requirements applied during the nine calendar years following original owner’s death. In February 2022, the IRS issued proposed regulations implementing the SECURE Act’s RMD provisions. The proposed regulations caused additional confusion related to the RMD requirements. This led the IRS to issue Notice 2022-53<sup>4</sup> in August 2022 and then Notice 2023-54<sup>5</sup> in July 2023 (covered later.)

This section reviews the requirements of the proposed regulations as well as the implications of Notices 2022-53 and 2023-54.

**Note.** This section uses the term “account owner” to refer to the deceased owner of a plan, regardless of whether the plan is an IRA, an annuity, or a qualified plan provided by the decedent’s employer.

## SECURE ACT CHANGES

The SECURE Act sharply curtailed the use of stretch IRAs in planning for inherited IRAs. For a DB, the period for distributions is reduced from their life expectancy to 10 years. Except for surviving spouses and other EDBs, the law requires DBs of IRAs to withdraw all remaining funds within 10 calendar years from the calendar year of the account owner’s death.

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<sup>1</sup> SECURE Act of 2019, PL 116-94.

<sup>2</sup> IRC §401(a)(9).

<sup>3</sup> IRC §401(a)(9)(H)(i).

<sup>4</sup> IRS Notice 2022-53, 2022-45 IRB 437.

<sup>5</sup> IRS Notice 2023-54, 2023-31 IRB 382.

The revenue provisions of the SECURE Act made modifications to RMDs for DBs where the account owner dies before receiving the entire distribution of the account. Specifically, §401 of the Act amends IRC §401(a)(9) by adding a special rule, “that except in the case of a beneficiary who is not a designated beneficiary, subparagraph (B)(ii) shall be applied substituting ‘10 years’ for ‘5 years.’”<sup>6</sup>

The Act did not change how the 5-year rule is applied to **nondesignated beneficiaries**. Under the 5-year rule, the entire remaining interest must be distributed within five years after the account owner’s death without any requirement for RMDs.<sup>7</sup> Because Congress simply substituted 10 years for five years, many advisors interpreted the statute to mean that the remaining balance could be distributed at any time within the 10 years, even on the last day of the last calendar year.

Reflecting this interpretation, IRS Pub. 590-B, *Distributions from Individual Retirement Arrangements (IRAs)*, for 2020 and 2021 stated the following.

*The 10-year rule requires the IRA beneficiaries who are not taking life expectancy payments to withdraw the entire balance of the IRA by December 31 of the year containing the 10th anniversary of the owner’s death... The beneficiary is allowed, but **not required**, to take distributions prior to that date. [emphasis added]*

## IRS Proposed Regulations<sup>8</sup>

In February 2022, the IRS issued proposed regulations that require DBs to receive **annual** distributions from inherited plans and IRAs. Waiting until the end of the 10-year period would not be adequate. In the proposed regulations, the IRS interpreted §401(a)(9)(B)(i) to require annual distributions be taken at least as rapidly as the account owner was taking distributions prior to death.

Following this logic, the IRS proposed that beneficiaries must start distributions during the calendar year following the original owner’s death. For example, if an IRA owner aged 75 died in 2021, having already started RMDs, their beneficiaries must start distributions no later than December 31, 2022. The SECURE Act otherwise removed a provision distinguishing beneficiary RMDs if the account owner died before their required beginning date (RBD). With the SECURE Act, the rules for distributions apply regardless of whether the deceased account owner had begun taking distributions.<sup>9</sup>

In the explanation to the proposed regulations, the IRS states as an example that if an account owner dies **after their RBD**, then a DB that is not an EDB is responsible for taking distributions in the following years until the conclusion of the calendar year that includes the **9th anniversary** of the account owner’s death. The remaining balance of the account owner’s interest in the IRA or qualified plan must be distributed entirely in the following year.<sup>10</sup>

The proposed regulations apply to traditional IRAs, that are either individual retirement accounts or individual retirement annuities. They also apply to Roth IRAs, annuity contracts, custodial accounts, IRC §403(b) retirement accounts, and IRC §457(b) eligible deferred compensation plans.

<sup>6</sup> IRC §401(a)(9)(H)(i).

<sup>7</sup> IRC §401(a)(9)(B)(ii).

<sup>8</sup> 87 Fed. Reg. 10504 (Feb. 24, 2022); Prop. Treas. Regs. §§1.401(a)(9)-1, 1.401(a)(9)-2, and 1.401(a)(9)-5.

<sup>9</sup> IRC §401(a)(9)(H)(i)(II).

<sup>10</sup> 87 Fed. Reg. 10504, 10514 (Feb. 24, 2022).

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**Scope of Proposed Regulations.** The SECURE Act's new RMD requirement affected a wide range of retirement accounts.<sup>11</sup> By referencing §401(a)(9)(B)(ii), the 10-year RMD requirement affects the following types of retirement accounts.<sup>12</sup>

- Traditional IRAs<sup>13</sup>
- Roth IRAs<sup>14</sup>
- Qualified pensions
- Qualified profit-sharing plans
- Stock bonus plans
- Annuity contracts<sup>15</sup>
- Retirement income accounts (§403(b) plans)
- Eligible deferred compensation plans<sup>16</sup>
- Governmental plans
- Collective bargaining agreements
- Other custodial accounts

Simplified employee pensions (SEPs) and savings incentive match plans for employees (SIMPLE) IRAs are mentioned in a proposed regulation that also ties them to the new 10-year distribution rules.<sup>17</sup> The proposed regulations also apply to collective bargaining agreements and governmental plans, although the SECURE Act provisions for these plans have varying effective dates.

## RMDs

Under the proposed regulations, RMDs for DBs must begin in the calendar year following the account owner's death.<sup>18</sup> For example, the DBs of an IRA owner who died on January 2, 2023, would have until December 31, 2024, to receive the first IRA distribution. Further, the proposed regulations provide that all funds must be distributed by the end of the 10th year following the death of the account owner. The IRS uses the example that if the owner died in 2021 then the entire balance must be distributed by the end of 2031.

**Caution.** The following examples in this section are based on the **proposed** regulations for DBs inheriting IRAs after December 31, 2019. **Finalization** of the regulations is not likely to occur until 2024. The final regulations may change the rules from the proposed regulations that are reflected in the following examples.

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<sup>11</sup> IRC §401(a)(9)(H).

<sup>12</sup> IRC §401(a)(9).

<sup>13</sup> IRC §§408(a)(6) and (b)(3), referencing §401(a)(9).

<sup>14</sup> IRC §408A(c)(5).

<sup>15</sup> IRC §403(b)(10).

<sup>16</sup> IRC §457(b).

<sup>17</sup> Prop. Treas. Reg. §1.408-8(a)(4).

<sup>18</sup> Prop. Treas. Reg. §1.401(a)(9)-3(c)(3).

**Example 1.** Faith, age 91, died in May 2021 after receiving her RMD from her traditional IRA for 2021. Her daughter, Hope, is the only beneficiary of her IRA. She was born in March 1956 and celebrated her 65th birthday in 2021 before her mother passed away.

Based on the proposed regulations, Hope is required to take the first RMD from this inherited IRA on or before December 31, 2022. However, Hope's tax preparer advised her that based on IRS Notice 2023-54 (discussed later), Hope can wait until **2024** to take the first RMD. Hope is still required to withdraw any remaining balance in the account by the end of 2031.

## Designated Beneficiaries<sup>19</sup>

A DB is any individual whom the account owner has named as a beneficiary of the account. Individuals need not be specifically named as beneficiaries, but they must be identifiable by class, even if the class of individuals may increase or decrease in size. For example, if a person names "my children" as their beneficiary on the account and it is possible to determine who the oldest child is, the beneficiaries will be treated as DBs.

Under Proposed Treas. Reg. §1.401(a)(9)-4(b), **any beneficiary that is not an individual** will not be a DB. The beneficiary must be a DB to benefit from a 10-year distribution period. If the only beneficiary is the owner's estate, then the distribution period would be five years. If there are multiple beneficiaries and **all beneficiaries are considered DBs**, then the assets of the inherited retirement plan can be distributed over 10 years. However, if **even one beneficiary** does not qualify as a DB, the entire retirement plan balance must be distributed within five years.<sup>20</sup>



### Practitioner Planning Tip

The DBs can avoid this result by distributing the balance due to the nondesignated beneficiary by the end of the calendar year following the account owner's death. The remaining balance is then due to only DBs and the 10-year rule applies.<sup>21</sup>

If a retirement account has any unqualified DBs or EDBs, it must be distributed according to the 5-year rule, requiring the account to be distributed by the end of the 5th calendar year after the account owner's death. Tax practitioners should suggest their clients regularly review their retirement account beneficiaries.

## Calculating RMD for DBs

To calculate an RMD, a DB must consider factors such as life expectancy, the value of the retirement plan, and whether there are multiple beneficiaries. RMDs are determined using the following equation.

$$\text{RMD} = \frac{\text{Account value at the end of the valuation year}}{\text{Beneficiary's life expectancy}}$$

<sup>19</sup> IRC §401(a)(9)(E)(i).

<sup>20</sup> IRC §401(a)(9)(H)(i); Treas. Reg. §1.401(a)(9)-3. See A-4 (a)(2).

<sup>21</sup> Prop. Treas. Reg. §1.401(a)(9)-8.

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**Life Expectancy.** In the proposed regulations, the IRS did not make any changes to the life expectancy tables from IRS Pub. 590-B which are used in determining the amount of an RMD. If the account owner dies after the RBD, the denominator used to calculate the RMD of the DB is the greater of the DB's remaining life expectancy and the account owner's remaining life expectancy.<sup>22</sup> The DB's life expectancy is determined using the beneficiary's age in the year after the account owner's death,<sup>23</sup> generally referring to Appendix B in IRS Pub. 590-B. Each year after that, however, the denominator is reduced by one. The deceased account owner's life expectancy is determined using their age in the year of death. Unless the DB is older than the account owner, the DB's life expectancy should result in smaller distributions during the nine years.

**Example 2.** Use the same facts as **Example 1**. Because Hope had her 65th birthday in the year her mother died, she turns 66 in the year immediately after the year of her mother's death. Therefore, she determines that her life expectancy, for RMD purposes, is 22.0 years, as shown in the following table, excerpted from IRS Pub. 590-B. Presumably, 22.0 is greater than Faith's life expectancy, so Hope uses 22.0 as the denominator for computing her RMD in 2022 should she choose to take an RMD in 2022.

| <b>Table I</b><br><b>(Single Life Expectancy)</b><br><b>(For Use by Beneficiaries)</b> |                        |            |                        |
|----------------------------------------------------------------------------------------|------------------------|------------|------------------------|
| <b>Age</b>                                                                             | <b>Life Expectancy</b> | <b>Age</b> | <b>Life Expectancy</b> |
| 60                                                                                     | 27.1                   | 91         | 5.3                    |
| 61                                                                                     | 26.2                   | 92         | 4.9                    |
| 62                                                                                     | 25.4                   | 93         | 4.6                    |
| 63                                                                                     | 24.5                   | 94         | 4.3                    |
| 64                                                                                     | 23.7                   | 95         | 4.0                    |
| 65                                                                                     | 22.9                   | 96         | 3.7                    |
| 66                                                                                     | 22.0                   | 97         | 3.4                    |
| 67                                                                                     | 21.2                   | 98         | 3.2                    |
| 68                                                                                     | 20.4                   | 99         | 3.0                    |
| 69                                                                                     | 19.6                   | 100        | 2.8                    |

The life expectancy is significant even after Hope receives the first RMD. The denominator she uses in 2023 is **not** the value corresponding to age 67, her age in 2023, but one less than the value in the year after her mother's death (i.e., 21.0 years.) Thus, if Hope did not receive an RMD in 2022, she cannot use her life expectancy based on her age of 67 in the year of her first RMD (21.2 years).

If the account owner dies before the RBD, then the DB determines the RMDs for the first nine years using the same method previously described but the **DB's life expectancy is used.**<sup>24</sup> This number is referred to in the section as the "beneficiary's life expectancy."

In each subsequent year, the denominator is reduced by one.

<sup>22</sup> Prop. Treas. Reg. §1.401(a)(9)-5(d)(1)(ii).

<sup>23</sup> Treas. Reg. §1.401(a)(9)-5. See A-5(c)(1).

<sup>24</sup> Prop. Treas. Reg. §1.401(a)(9)-5(d)(2).

**Account Value.** To calculate the RMD amount, the value of the retirement plan must also be known. The key information for the value of the retirement plan is its value at the end of the previous year, which the regulations refer to as the “valuation year.”<sup>25</sup> The account’s balance is decreased for any distributions for the valuation calendar year occurring after the valuation date.<sup>26</sup>

For example, if a taxpayer missed their RMD in the prior year, in calculating the current year RMD, they should reduce the prior year account value by the missed RMD amount.

Two more unusual situations can affect the value of the retirement plan.<sup>27</sup>

- Qualified longevity annuity contracts<sup>28</sup>
- Retirement plans rolled over into another plan, particularly when these plans are merged or consolidated

**Example 3.** Use the same facts as **Example 2**. Hope did not calculate an RMD during 2021, as Faith already received the RMD for that year. The retirement account’s value on December 31, 2021, was \$100,000. At the end of each year, the account is credited with 4% interest based on the year-end value of the account. Because Hope did not receive a distribution during 2022, the value of the account on December 31, 2022, is \$104,000.

Hope may choose to receive an RMD in 2023 of \$4,953 ( $\$104,000 \text{ value of account} \div 21.0 \text{ years}$ ). The denominator of 21.0 is based on Hope’s deemed life expectancy of 22.0 in 2022 reduced by 1. Although Hope could choose to receive a larger distribution, she does not.

At the end of 2023, the value of the retirement account that Hope has inherited is \$103,009 ( $(\$104,000 \text{ value at the end of 2022} - \$4,953 \text{ distribution for 2023}) + (\$104,000 - \$4,953 \text{ distribution}) \times 4\% \text{ interest}$ ). Her distribution during 2024 must be at least \$5,151 ( $\$103,009 \div 20.0 \text{ years}$ ).

**Note.** This example simplifies calculations for illustrative purposes. It shows how RMDs may increase annually because the denominator decreases each year. Although this process reduces the retirement plan balance, beneficiaries should still plan for a significant distribution in the 10th year following the death of a retirement plan owner who designated them as a beneficiary.



### Practitioner Planning Tip

Knowing that the money must all come out by the end of the 10th year, taxpayers may prefer to take larger distributions if they have lower tax years. Tax practitioners should consider multiple year projections for taxpayers with inherited IRA accounts.

<sup>25</sup> Treas. Reg. §1.401(a)(9)-5, A-3(a); Prop. Treas. Reg. §1.401(a)(9)-5(b)(2).

<sup>26</sup> Ibid, A-3(c).

<sup>27</sup> Ibid, A-3(d) and (e).

<sup>28</sup> Qualified longevity annuity contracts are annuity contracts purchased from an insurance company. Requirements for qualified longevity annuity contracts are listed in Treas. Reg. §1.401(a)(9)-6, A-17.

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The same timeline applies to Roth IRAs.<sup>29</sup> Even though the retirement plan owner of a Roth IRA is not required to receive RMDs during their lifetimes,<sup>30</sup> the DB of a Roth IRA must receive distributions following the rules to withdraw funds from an inherited Roth plan within 10 calendar years of the account owner's death. However, if the account owner had the Roth IRA for at least five years prior to death, the distributions from the Roth IRA will not be taxable. Consequently, DBs may prefer to withdraw as little as possible from an inherited Roth IRA.

**Multiple Beneficiaries.** When an account owner designates multiple beneficiaries, the oldest DB's life expectancy applies for all beneficiaries.<sup>31</sup> For example, if two siblings were both beneficiaries of a parent's IRA but were born 15 years apart, the younger sibling must compute RMDs using their older sibling's life expectancy. Thus, the younger sibling has distributions in the years immediately following the parent's death that are greater than they would have been. In either case, the entire account must be distributed within 10 years.

However, DBs can instead create separate accounts no later than December 31 of the year following the year of the account owner's death.<sup>32</sup> Once they establish separate accounts, the RMD for each DB is determined by their own life expectancy, not that of the oldest beneficiary.

**Example 4.** Use the same facts as **Example 2**, except that Hope has a brother, Justin, who is also a beneficiary. Justin was born in 1962 and turned 60 in **2022**, the year following their mother's death. Justin and Hope are 50% beneficiaries of their mother's retirement plan.

Because Hope and Justin divide their mother's retirement account into separate accounts, Justin can use his life expectancy to calculate his RMDs, rather than that of his older sister. Both Justin's and Hope's inherited IRA accounts have \$52,000 at the end of 2022. Assuming that Justin also waits until 2023 to receive the first distribution, his RMD for that year is \$1,992 (\$52,000 value of account ÷ 26.1 years Justin's life expectancy in 2023), while Hope's RMD is \$2,477 (\$52,000 value of account ÷ 21.0 years Hope's life expectancy in 2023).

Although Justin can receive distributions at a slower rate than Hope in the nine years following their mother's passing, both Justin and Hope must completely distribute any remaining balances during the 10th year, 2031. If both Justin and Hope receive only the RMDs during the first nine years, Justin can expect a larger distribution in 2031 than Hope because his account balance has a larger expected balance.

## Calculating RMDs for EDBs

The SECURE Act's changes **did not affect all beneficiaries** in the same way. Congress chose to establish a new class of beneficiaries with special rules related to inherited retirement accounts. These beneficiaries are known as EDBs.

- The surviving spouse of the retirement plan owner
- Minor children of the retirement plan owner
- Disabled individuals<sup>33</sup>
- A chronically ill individual provided that a doctor has certified that the illness is expected to be lengthy<sup>34</sup>
- Another individual who does not meet any of the previous four conditions and is not more than 10 years younger than the deceased retirement plan owner<sup>35</sup>

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<sup>29</sup> IRC §408A.

<sup>30</sup> IRC §408A(c)(4).

<sup>31</sup> Prop. Treas. Reg. §1.401(a)(9)-5(f)(1)(i).

<sup>32</sup> Treas. Reg. §1.401(a)(9)-8(a) and (b).

<sup>33</sup> IRC §72(m)(7).

<sup>34</sup> IRC §7702B(c)(2).

<sup>35</sup> IRC §401(a)(9)(E)(ii)(v).



In general, these individuals are not subject to the requirement that all retirement plan funds be distributed by the end of the 10th year following the original owner's passing.<sup>36</sup> However, a minor child is exempt from the rules only for as long as they are minors. A proposed regulation puts the age of majority at 21 years.<sup>37</sup>

**Surviving Spouses.** Treatment for surviving spouses has undergone changes both under the SECURE Act and the SECURE 2.0 Act (covered extensively in the next section of the chapter).

**From the SECURE Act.** Surviving spouses can elect to treat their deceased spouse's IRA as their own assuming that the surviving spouse is the sole beneficiary.<sup>38</sup> By doing so, the surviving spouse becomes the account owner, and RMDs are determined based on the surviving spouse's age. They can accomplish this by either of the following.<sup>39</sup>

- Retitling the account as their own rather than as a beneficiary
- **Not** receiving a distribution from the inherited IRA within the required time, generally the end of the next year, if the deceased had received their RMD prior to, but in the year of, their death
- Making a contribution of their own to the inherited IRA

They may only make this election if there are no other beneficiaries of the IRA and there are no restrictions on their ability to receive distributions from the IRA.<sup>40</sup> If the surviving spouse does not treat themselves as the owner of their deceased spouse's retirement account, they must receive RMDs no later than the first year following their spouse's passing.<sup>41</sup>

Although they are not subject to the rule requiring total distribution of the retirement account by the end of 10 years following their spouse's passing, the amount must be distributed according to the surviving spouse's life expectancy.

**From the SECURE 2.0 Act.**<sup>42</sup> Taking effect in 2024, this legislation gives surviving spouses more flexibility to treat the inherited IRA as their own. They do not need to receive RMDs until the date the deceased spouse would have been required to receive RMDs had they lived to that age. The legislation directs the IRS to amend regulations to permit surviving spouses to use the uniform lifetime table.<sup>43</sup>

This limit is significant if the spouse who died was younger than the surviving spouse.

**Example 5.** Henry, age 66, and Wendy, age 61, married, both have IRAs that names the other spouse as the sole beneficiary. Wendy was born in December 1962. Sadly, Wendy passes away suddenly in January 2024. Henry can delay receipt of his first RMD until Wendy would have reached her RBD. Because Wendy would have turned 73 in 2035, her applicable age is 74. Thus, were it not for her premature death, Wendy would have reached her applicable age in 2036. This provision allows Henry to delay the receipt of RMDs from Wendy's IRA until April 1, 2037, after he reaches the beginning date for his own RMDs.

**Note.** Before this provision of the SECURE 2.0 Act goes into effect on January 1, 2024, surviving spouses can treat IRAs inherited from their spouses as their own, using their own RBD. This provision of the SECURE 2.0 Act requires them to start using their deceased spouses' RBD, likely requiring earlier RMDs if the deceased spouse was older.

<sup>36</sup> IRC §401(a)(9)(H)(ii), which exempts EDBs from the requirement to distribute the inherited retirement account completely.

<sup>37</sup> Prop. Treas. Reg. §1.401(a)(9)-4(e)(3).

<sup>38</sup> Treas. Reg. §1.408-8, A-5; Prop. Treas. Reg. §1.408-8(c).

<sup>39</sup> Prop. Treas. Reg. §1.408-8(c)(2).

<sup>40</sup> Treas. Reg. §1.408-8, A-5 (a).

<sup>41</sup> Prop. Treas. Reg. §1.408-8(c)(3).

<sup>42</sup> SECURE 2.0 Act of 2022, PL 117-328, §327.

<sup>43</sup> IRS Pub. 590-B, *Distributions from Individual Retirement Arrangements (IRAs)*, p. 65 (2022).

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**Minor Children.**<sup>44</sup> Children are minors until they attain the age of 21. At that time, the 10-year mandatory distribution rule begins.

**Disabled Individuals.**<sup>45</sup> Provided the beneficiary was disabled when the retirement plan owner died, an individual is considered an EDB, and thereby exempt from the 10-year mandatory distribution rule. For a person who is at least 18 years old, disabled is defined as a condition preventing an individual from partaking in “substantial gainful activity” because of a physical or mental condition.<sup>46</sup> This judgment must be supported by a doctor’s opinion that the impairment is of indefinite duration or result in the individual’s death.

An individual younger than 18 is considered disabled if they have a physical or mental impairment that results in “marked and severe functional limitations.” This must be supported by a doctor’s opinion that the condition is of indefinite duration or result in the individual’s death.

**Chronically Ill Individuals.**<sup>47</sup> Chronically ill individuals are also exempt from the 10-year distribution requirement. The designation must be supported by a certification of a licensed health care practitioner that the individual cannot perform two activities of daily living.<sup>48</sup> This illness should be indefinite and explicitly longer than 90 days.

**Multi-Beneficiary Trusts.**<sup>49</sup> Trusts may be established for individuals who are either disabled or chronically ill under the definitions provided by the SECURE Act. If **at least one** beneficiary of a trust is either disabled or chronically ill, then the provisions for EDBs apply to any disabled or chronically ill beneficiary.<sup>50</sup> This treatment is contingent on the trust containing terms that:<sup>51</sup>

- Provide for its immediate separation into separate trusts for each beneficiary as soon as the retirement plan owner dies,
- No beneficiary who is not disabled or chronically ill can receive a benefit under the trust until the death of the last disabled or chronically ill individual, and
- Any individual who is not disabled or chronically ill is a DB of the trust.

**Individuals Younger than the Retirement Plan Owner by 10 Years or Less.**<sup>52</sup> Unless there is impairment or chronic illness, an individual who is within 10 years of the retirement plan owner’s age is also exempt from the 10-year distribution requirement.

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<sup>44</sup> Prop. Treas. Reg. §1.401(a)(9)-3.

<sup>45</sup> Prop. Treas. Reg. §1.401(a)(9)-4(e)(4).

<sup>46</sup> IRC §72(m)(7).

<sup>47</sup> Prop. Treas. Reg. §1.401(a)(9)-4(e)(5).

<sup>48</sup> IRC §7702B(c)(2).

<sup>49</sup> IRC §401(a)(9)(H)(iv); 87 Fed. Reg. 10504, 10505 (Feb. 24, 2022).

<sup>50</sup> IRC §§401(a)(9)(H)(iv) and (v).

<sup>51</sup> IRC §401(a)(9)(H)(iv).

<sup>52</sup> *Beneficiary IRAs: A guide to the RMD maze*. Roane, Dayna E. Mar. 30, 2023. Journal of Accountancy. [[www.journalofaccountancy.com/issues/2023/apr/beneficiary-iras-a-guide-to-the-rmd-maze.html](http://www.journalofaccountancy.com/issues/2023/apr/beneficiary-iras-a-guide-to-the-rmd-maze.html)] Accessed on Jun. 19, 2023.

## IRS Notice 2022-53<sup>53</sup>

In response to comments the IRS received related to the RMD provisions in the proposed regulations, the IRS issued Notice 2022-53 stating that they intend to issue final regulations with respect to RMDs that will apply no earlier than 2023. Further, the IRS provided guidance related to RMDs for 2021 and 2022. They announced that the IRS would not assert any **excise** tax assessments for persons not receiving RMDs during those years.<sup>54</sup>

**Note.** When the SECURE Act was passed, the excise tax on missed RMDs was 50%. The SECURE 2.0 Act reduced the penalty on these missed distributions. If the taxpayer corrects the oversight within a correction window, the penalty is only 10%. Otherwise, the penalty is halved to 25%.<sup>55</sup>

The notice reiterated the language from the proposed regulations in support of RMDs for DBs. For DBs who inherited IRAs from account owners who died in 2020 or 2021, the notice provides relief from penalties if no RMDs were taken in 2021 or 2022. However, this notice does not provide any relief for 2023.

## IRS Notice 2023-54<sup>56</sup>

In July 2023, the IRS announced that it would again suspend enforcement of the RMD requirements it announced during 2022. Accordingly, the IRS has stated that it will not assess excise tax against DBs who do not receive withdrawals from inherited IRAs during 2023.<sup>57</sup> The earliest these penalties would apply is 2024.

## SECURE 2.0 ACT

President Biden signed the SECURE 2.0 Act into law on December 29, 2022, as part of the Consolidated Appropriations Act of 2023.<sup>58</sup> Congress designed the Act to help taxpayers save for retirement by changing retirement provisions at the taxpayer, plan, and business levels. The Act aims to incentivize retirement savings at the taxpayer level while making it easier for employers to offer retirement savings benefits.

Taxpayers and employers should evaluate the expanding retirement planning opportunities to leverage additional tax savings and reach retirement goals quicker than before. Some provisions of the SECURE 2.0 Act went into effect as of January 1, 2023. As such, developing an understanding of the changes and concepts within the Act is critical in implementing timely strategies for retirement. This section covers important topics within the SECURE 2.0 Act to assist in adapting to the changes and new opportunities that the Act introduced.

### RMD AGE DELAY

An RMD is the least amount of withdrawal a taxpayer must take from their retirement account each year once they have reached a certain age. The SECURE Act increased the age for RMDs from 70½ to 72.<sup>59</sup> The SECURE 2.0 Act further increases the age (discussed later). This section covers the concepts behind RMDs and the implications of the changes that SECURE 2.0 Act establishes.

<sup>53</sup> IRS Notice 2022-53, 2022-45 IRB 437.

<sup>54</sup> IRC §4974(a).

<sup>55</sup> *SECURE 2.0 Act of 2022*, PL 117-328, §302, amending IRC §4974(a).

<sup>56</sup> IRS Notice 2023-54, 2023-31 IRB 382.

<sup>57</sup> IRC §4974(c).

<sup>58</sup> *Consolidated Appropriations Act of 2023*, PL 117-328, Division T.

<sup>59</sup> *SECURE Act of 2019*, PL 116-94, §114.

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## History Behind RMDs

The Employee Retirement Income Security Act of 1974 legalized RMD rules.<sup>60</sup> Throughout the years, there have been instances where the government halted RMDs. These notable events include the Housing Market Crisis of 2008 and the recent COVID-19 pandemic. In each instance, Congress passed emergency legislation to provide temporary relief for taxpayers.<sup>61</sup>

These periods of temporary relief only lasted one year, prompting the question of why Congress is eager to enforce RMDs. Many retirement accounts operate under tax-deferred contributions, meaning taxpayers are only taxed when they withdraw funds. If taxpayers avoid taking withdrawals, their funds may move to an estate after death, which could free large balances from estate tax under the lifetime exemption.<sup>62</sup> Consequently, taxing authorities enforce RMDs to prevent taxpayers from completely avoiding tax by accumulating wealth in an IRA for beneficiaries to inherit.

Additionally, RMDs provide another income stream for the IRS through penalties associated with noncompliance with RMD rules. While the SECURE 2.0 Act decreased these penalties from 50% to 25% starting January 1, 2023, RMD penalties have the potential to provide a steady stream of revenue.<sup>63</sup> For example, on a \$50,000 RMD, the IRS may impose \$12,500 in penalties (\$50,000 x 25%). However, if the offending taxpayer remedies the RMD distribution within a 2-year period, the penalty drops to 10%.<sup>64</sup> As mentioned previously, the IRS will not assess penalties until 2024.

**Note.** There has been speculation that the decrease in penalty for correcting missed RMD payments would result in the IRS no longer waiving missed RMD penalties as it had in the past. Before the enactment of the SECURE 2.0 Act, when taxpayers could establish that they missed their RMD due to a reasonable error and they took reasonable steps to remedy the error, the IRS could waive the penalty.<sup>65</sup> Although the penalty has been reduced, the IRS's ability to waive the penalties appears to remain intact. Taxpayers should emphasize that the error for missing the RMD was due to reasonable cause, as simply correcting the error appears to decrease the penalty instead of resulting in a waiver.

## New Applicable Age for RMDs

The following are the new applicable ages for RMDs.<sup>66</sup>

- For the **2022** tax year, the RMD age is **72**.
- For tax years **2023** through **2032**, the RMD age is **73**.
- For tax years **2033** and on, the RMD age is **75**.

Taxpayers over 73 years old will not see any impact on their current RMDs. The SECURE 2.0 Act most profoundly affects taxpayers who are planning for retirement or are nearing the RMD age. Some taxpayers will delay RMDs, while others may perceive the time difference as immaterial.

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<sup>60</sup> *Employee Retirement Income Security Act of 1974*, PL 93-406, §408.

<sup>61</sup> *Coronavirus Relief for Retirement Plans and IRAs*. May 31, 2022. IRS. [www.irs.gov/newsroom/coronavirus-relief-for-retirement-plans-and-iras] Accessed on Mar. 6, 2023; IRS News Rel. 2009-85 (Sep. 24, 2009).

<sup>62</sup> IRS Pub. 590-B, *Distributions from Individual Retirement Arrangements (IRAs)*; IRC §2010(a).

<sup>63</sup> *SECURE 2.0 Act of 2022*, PL 117-328, §302.

<sup>64</sup> *Ibid.*

<sup>65</sup> *Retirement Plan and IRA Required Minimum Distributions FAQs*. Mar. 14, 2023. IRS. [www.irs.gov/retirement-plans/retirement-plan-and-ira-required-minimum-distributions-faqs] Accessed on Apr. 25, 2023.

<sup>66</sup> *SECURE 2.0 Act of 2022*, PL 117-328, §107.

## Considerations of Starting RMDs Later in Life

Taxpayers should consider the consequences of starting RMDs later in life. For some taxpayers, the RMD age delay provides an incentive to work later in life. In doing so, they can continue making retirement contributions if they have earned income. If the retirement accounts are Roth or traditional IRA accounts, taxpayers can contribute to them regardless of their age.<sup>67</sup> Delaying RMDs an additional year can have a significant impact on accumulated income.<sup>68</sup> By delaying the RMDs, taxpayers are able to have funds remain in their retirement accounts and continue to accumulate earnings tax free.

However, additional wealth accumulation subjects taxpayers to an increase in the annual RMD once the taxpayer reaches the applicable age. With larger distributions and potentially higher tax rates, it is more likely they will be subject to a higher income tax. Furthermore, starting RMDs later in life increases the potential of leaving assets within one's estate. Taxpayers should consider the trade-off between wealth accumulation and desired retirement lifestyle, asking themselves if delaying RMDs for one year is worth working another 12 months or limiting current retirement expenses.

For taxpayers with large portfolios and other avenues of income, starting RMDs later in life can make sense from a financial and tax standpoint. These taxpayers can defer taxable RMDs, resulting in lower income to report on their tax returns compared to if they had taken their RMDs. These factors are positive considerations for high-net-worth taxpayers who wish to maximize funds to pass down to their beneficiaries while minimizing income taxes at the same time.

**Example 6.** John and Sally are siblings born one year apart in 1959 and 1960, respectively. John will reach age 73 in 2032, while Sally will be 73 in 2033. Because the RMD age delay will increase to 75 in 2033, the first year in which Sally is required to take an RMD is 2035, when she turns 75. Assume both John and Sally have \$1 million in their retirement accounts at age 72, and their accounts are earning an annualized 10% return. The table below outlines the differences in RMD withdrawals and average account balances based on the additional two years Sally can delay RMDs.

|                       | Age       |           |           |           |           |
|-----------------------|-----------|-----------|-----------|-----------|-----------|
|                       | 72        | 73        | 74        | 75        | 76        |
| John RMD              | \$ 0      | \$ 37,736 | \$ 41,509 | \$ 45,475 | \$ 49,811 |
| John account balance  | 1,000,000 | 1,058,490 | 1,118,680 | 1,180,525 | 1,243,785 |
| Sally RMD             | 0         | 0         | 0         | 49,187    | 53,877    |
| Sally account balance | 1,000,000 | 1,100,000 | 1,210,000 | 1,276,894 | 1,345,319 |

**Note.** The calculation of RMD distributions and account balances includes compounding interest annually.<sup>69</sup>

As the table illustrates, Sally's account balance earns higher growth despite the larger RMD when looking at the variance in account balances during ages 75 and 76 between John and Sally. The additional two years that Sally was able to retain funds in her account from ages 73 to 74 and accumulate earnings results in her RMD being higher than John's, but she is still able to maintain a higher ending account balance. Additionally, Sally did not have to pay income tax on RMDs when she was 73 and 74 years of age.

<sup>67</sup> Roth IRAs. Oct. 26, 2022. IRS. [www.irs.gov/retirement-plans/roth-iras] Accessed on Mar. 6, 2023.

<sup>68</sup> What Is The Average Return Of The Stock Market? Thune, Kent. Jan. 2, 2023. Seeking Alpha. [seekingalpha.com/article/4502739-average-stock-market-return] Accessed on Mar. 6, 2023.

<sup>69</sup> Required Minimum Distribution Calculator. Jan. 1, 2022. Investor.gov. [www.investor.gov/financial-tools-calculators/calculators/required-minimum-distribution-calculator] Accessed on Mar. 6, 2023.

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## ADDITIONAL CATCH-UP CONTRIBUTIONS

Catch-up contributions allow taxpayers nearing retirement to make additional contributions to their retirement accounts. This provision intends to help taxpayers make up for prior years when they could not contribute as much and may currently be in a financial position to bolster their retirement accounts.

Prior to the enactment of the SECURE 2.0 Act, taxpayers over 50 years old could make catch-up contributions of up to \$7,500 to their retirement plans. Section 109 of the SECURE 2.0 Act extends higher catch-up contributions to taxpayers, age 60 through 63. This provision gives them the ability to save extra money during what is likely their peak earning years. Most taxpayers in this age range have lower expenses and higher incomes. This age range is possibly the best time to put away extra money toward retirement. The following are specifics taxpayers should know.<sup>70</sup>

- Possible contributions are increased to either \$10,000 or 150% of the regular catch-up amount, whichever is greater.
- Contributions depend on inflation (indexed after 2025) but will at least be **\$10,000**.
- Only taxpayers between the age of 60 and 63 can leverage the additional catch-up contributions. For taxpayers who have reached age 50 but not 60, the existing catch-up provisions remain in effect.
- Individuals with wages exceeding \$145,000 may only make additional catch-up contributions to Roth accounts.<sup>71</sup>
- Additional catch-up contributions do not go into effect until January 1, 2025.

**Note.** The SIMPLE plan limit for catch-up contributions is \$3,500 for 2023.<sup>72</sup> Section 108 of the SECURE 2.0 Act allows adjustments for inflation to IRA catch-up contributions beginning on January 1, 2024. Section 109 applies to all other retirement plans.<sup>73</sup>

**Caution.** Currently, there is a drafting error in the SECURE 2.0 Act regarding catch-up contributions, resulting in individuals being unable to make catch-up contributions to pre-tax or Roth accounts after December 31, 2023. This appears to be an oversight and unintended by Congress. It is unknown whether Congress must amend the legislation or if the Treasury is able to ignore the drafting error. Practitioners should watch for guidance on the issue as the end of 2023 approaches.<sup>74</sup>

<sup>70</sup> SECURE 2.0 Act of 2022, PL 117-328, §109.

<sup>71</sup> Ibid, §603.

<sup>72</sup> IRS Notice 2022-55, 2022-45 IRB 443.

<sup>73</sup> SECURE 2.0 Act of 2022, PL 117-328, §108.

<sup>74</sup> See *Major SECURE 2.0 Error Puts Catch-Ups in Jeopardy: ARAs Graff*. Sullivan, John. Jan. 24, 2023. National Association of Plan Advisors. [www.napa-net.org/news-info/daily-news/major-secure-20-error-puts-catch-ups-jeopardy-ara's-graff] Accessed on Jul. 20, 2023.

## STUDENT LOAN PAYMENTS AS ELECTIVE DEFERRALS<sup>75</sup>

Many taxpayers might be unable to save for retirement because they have extensive student loan debt. In instances where employees make repayments on qualified student loans, employers can pay matching contributions to the employees' retirement accounts. The employees must be otherwise eligible for matching contributions.

Employers may rely on an employee's verbal payment confirmation for qualifying student loans. However, documentation should substantiate the match for qualification testing purposes. Plans can test student loan payments as a part of general discrimination testing or as a separate group. Student loan payments do not receive treatment as contributions to the plan outside of qualification testing.

### Employer Treatment

Employers that offer a §401(k), §403(b), §457(b), or SIMPLE IRA can modify their plan terms to include student loan payments as elective deferrals to the employer plan. This allows an employee to at least qualify for matching contributions from the employer and create some retirement savings while still paying down student loans. Employers will need to follow the same matching provisions for qualifying student loan payments as are provided for all employee deferrals.



### Practitioner Planning Tip

If an employer does not offer a qualifying retirement program, they cannot use the provisions under SECURE 2.0 Act, §110. Instead, these employers should consider offering a student loan repayment program as part of an Educational Assistance Program, which allows employers to allocate up to \$5,250 of employee compensation to student loans without incurring payroll taxes.<sup>76</sup> The inclusion of student loan repayments as a part of this program currently will expire at the end of 2025. Practitioners should review the requirements for a qualified eligible education assistance program.

The match, submittal, and vesting schedules remain the same as regular plan participants. Some employers may choose to remit contributions annually instead of with each payroll cycle for administrative purposes.

### Effective Date

**Section 110 of the SECURE 2.0 Act is not effective until January 1, 2024**, providing employers additional time to change plan documents and roll out a program.

**Example 7.** Sam is an employee at XYZ, Inc. Sam borrowed \$10,000 from a private lender to help pay for his college education. Sam has been paying the loan back \$200 per month. XYZ offers a §401(k) plan with a 3% employer match on elective deferrals. Sam does not currently contribute to the plan. XYZ amends its plan documents to provide that student loan repayments will be treated as elective deferrals beginning in 2024. Because Sam is making payments on a qualifying student loan, XYZ must establish a §401(k) account for Sam and make a matching contribution to his account for 2024. XYZ would contribute 3% of Sam's monthly \$200 loan payments, or \$6 a month totaling \$72 for the year. In this case, maintaining Sam's §401(k) account may be burdensome for XYZ.

<sup>75</sup> SECURE 2.0 Act of 2022, PL 117-328, §110.

<sup>76</sup> IRC §127.

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## NEW RMD RULES FOR SPECIAL NEEDS TRUSTS

It is not unusual for family members to establish a special needs trust as part of their estate planning when there are children with disabilities. The intention is to provide benefits to the children without compromising access to various government benefits. The SECURE Act provided special rules for disabled beneficiaries which required that a trust document satisfy certain requirements to avoid the 10-year rule.<sup>77</sup> The modification provided by the SECURE 2.0 Act provides some flexibility in the types of trust beneficiaries permitted.

### Clarification to the Original SECURE Act

Section 337 of the SECURE 2.0 Act changes the language surrounding certain trust beneficiaries of IRAs. Special needs trusts with a disabled person as an income beneficiary can now designate a charitable organization as a remainder beneficiary and have the remainder beneficiary treated as a DB. Absent this correction, the special needs trust would have a non-designated beneficiary and be subject to the 5-year rule. Section 337 goes into effect for the **2023 tax year**.

**Example 8.** Brad was born physically disabled and was 18 years old when his parents passed away. Before their passing, Brad's parents set up and funded a special needs trust to provide for his needs in the event of their deaths. Both parents had IRAs that designated Brad's special needs trust as the beneficiary of the accounts. Additionally, the special needs trust provided that a charitable organization specializing in Brad's illness would be the remainder beneficiary of the trust.

Brad's parents passed away in a tragic car accident in January 2023, just a week after the SECURE 2.0 Act clarified that charitable organizations named as remainder beneficiaries in special needs trusts would be considered DBs. If the special needs trust inherited the IRA accounts prior to the effective date of §337 of the SECURE 2.0 Act, the results would have been quite different. Although Brad would be an EDB under the SECURE Act and not subject to a shortened distribution period, the charity as a remainder beneficiary is a DB.

## CHANGES TO SIMPLE RETIREMENT PLANS

The SECURE 2.0 Act introduced changes for employers offering SIMPLE plans. This section discusses two of these changes; additional nonelective contributions and changes to elective deferral limits.

### Additional Nonelective Contributions to SIMPLE Plans

Section 116 of the SECURE 2.0 Act allows employers to make an additional nonelective contribution to SIMPLE plans for tax years beginning after December 31, 2023. This option supplements the existing requirement for employers to make contributions equal to a 2% nonelective contribution based on employee compensation or a 3% matching contribution of employee deferrals. There are limitations associated with the additional contributions. The additional contribution cannot exceed 10% of the employee's compensation or \$5,000 (indexed for inflation), whichever is lower, on a per-employee basis. Furthermore, the employer must apply the additional contributions uniformly with no discrimination between employees.

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<sup>77</sup> IRS Pub. 590-B, *Distributions from Individual Retirement Arrangements (IRAs)*.



## Changes to SIMPLE Plan Elective Deferral Limits

Section 117 of the SECURE 2.0 Act increases the SIMPLE plan elective deferral limits. Currently, the limit for elective deferrals is \$15,500 annually with an additional catch-up contribution of \$3,500 for individuals who are 50 or older. For employers with 25 or fewer employees who received at least \$5,000 of compensation in the prior year, the contribution limit, including the catch-up contribution, is increased by 10% above any usual cost of living increase. Employers with 26 to 100 employees can increase the employee deferral limit only if the employer match is also increased. The required employer match would be a 4% matching contribution or a 3% nonelective contribution.

**Note.** SIMPLE plans are only available for small employers with 100 or fewer employees.

**Example 9.** A company with 15 employees switches from making 3% matching contributions to making a larger, nonelective contribution. They already have an existing SIMPLE plan in which 10 employees participate.

Assume all employees make \$50,000 per year. If each employee makes \$50,000 per year, 10% of compensation would be \$5,000, which does not exceed the maximum limit. The maximum nonelective contribution is \$75,000 (\$5,000 per employee × 15 employees).

## IRC §529 PLAN ROLLOVERS TO ROTH IRAS<sup>78</sup>

Taxpayers may hesitate to contribute to §529 plans because of the stiff penalties for funds that a taxpayer does not use for educational purposes. To incentivize investment in §529 plans, Congress added §126 to the SECURE 2.0 Act. This section allows tax-free rollovers from long-term §529 accounts to Roth accounts. The beneficiary of the Roth account must be the same as the beneficiary of the §529 plan. Taxpayers whose children have graduated from college without using all the §529 funds can use this option rather than paying income taxes and a 10% penalty on earnings. **Section 126 goes into effect for distributions after December 31, 2023.**

## Rules for Rollover Distributions

There are specific rules that taxpayers must follow to have a qualifying rollover.

**15-Year Holding Period.** To qualify for the rollover, taxpayers must have maintained the §529 account for at least 15 years. This prevents taxpayers from taking advantage of the new provision by setting up new §529 plans that are never intended to be used for college. In addition, the qualifying distribution cannot exceed the aggregate amount contributed before the five years immediately preceding the distribution, including earnings on those contributions. This will prevent any back-end funding to maximize Roth IRA rollovers.

**Trustee-to-Trustee Distribution.** Congress specifically requires that §529 funds are paid to the Roth account in a trustee-to-trustee transfer. Therefore, taxpayers should not receive the funds personally, such as by check in the mail. The funds should move directly from the §529 account to the Roth IRA.

**Annual Limitation.** IRC §529 plan rollovers cannot exceed the annual limits of Roth IRA contributions. These amounts are adjusted each year for inflation. For the 2023 tax year, the Roth IRA limit is \$6,500, or \$7,500 for taxpayers 50 years of age or older.<sup>79</sup> This provision does not increase the amount that could otherwise be contributed on an annual basis.

**Aggregate Limitation.** Section 126 of the SECURE 2.0 Act provides a lifetime limit for rollovers from §529 accounts to Roth IRAs of \$35,000 per DB. Any excess funds withdrawn are subject to regular taxes and penalties.

<sup>78</sup> SECURE 2.0 Act of 2022, §126.

<sup>79</sup> *Retirement Topics — IRA Contribution Limits*. Dec. 21, 2022. IRS. [www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-ira-contribution-limits] Accessed on Mar. 31, 2023.

## Recipient of the Rollover

Only the named beneficiary of a §529 plan is entitled to have the balance rolled into a Roth IRA. Parents can open a §529 account for their child with one of the parents named as the beneficiary. This designation makes the parents eligible to roll over the funds to their Roth IRAs if their child does not use the money. If the child intends to use the funds, the parents can switch the beneficiary to the student to pay for educational expenses.<sup>80</sup>

**Example 10.** Sarah and Rick are married and have one daughter, Marie. Marie's wealthy grandparents fully fund a §529 account at Marie's birth. Rather than naming Marie as the account beneficiary, the grandparents listed Sarah and Rick as the beneficiaries. Marie is getting ready to attend college and receives a scholarship that covers all educational expenses. This means that she will not use her account for educational purposes. The account has been in place for 18 years. Rick and Sarah are both 50 years old, so their maximum annual Roth IRA contribution is \$7,500 per year. If Marie was the beneficiary, then the funds could only be rolled into a Roth IRA for her, and the rollover would be limited by her earned income.

**Note.** If the account beneficiary is changed, commentators have questioned whether this would restart the 15-year holding period.

## RMDS AND ROTH §401(K) PLANS<sup>81</sup>

Many employers have a Roth §401(k) option in their existing §401(k) plans. Employees who are not able to make Roth IRA contributions because of the income limitations find this to be a substantial benefit. However, unlike traditional Roth IRAs, the Roth §401(k)s were subject to RMD rules. Because the contributions to the accounts were made with after-tax dollars, the distributions were not taxable but the distributions stopped the income from growing tax-free.

Section 325 of the SECURE 2.0 Act changed the RMD requirement on Roth §401(k) accounts such that there are no RMD requirements until the death of the account owner. The change is effective to distributions starting on January 1, 2024. Any taxpayer distributions from employer-sponsored Roth plans in years before 2024 are subject to the old RMD rules.

This provision benefits employees, as they can put away more money than with Roth IRAs. Employer-sponsored Roth plans have higher contribution limits which include expanded contributions starting in 2025 once employees reach the age of 60 under §109. For 2023, the Roth §401(k) contribution limit is \$22,500, while Roth IRAs have a contribution limit of \$6,500.<sup>82</sup> Additionally, these plan participants are no longer required to start taking money out when they reach their RBD, leading to more potential growth and tax planning strategies.

**Example 11.** Jim and Gemma are a married couple who both have Roth accounts. Jim has a Roth IRA, and Gemma has a Roth §401(k). They were both born in 1950 and turn age 72 in 2023 before the SECURE 2.0 Act, §325 goes into effect. They both established their Roth accounts in 2007. The 5-year rule is satisfied for both Roth accounts. Jim is not required to take an RMD in 2023, but Gemma is because the plan is employer-sponsored. In 2024, neither of them is required to take RMDs from their accounts.

## NEW EARLY WITHDRAWAL EXCEPTION FOR DOMESTIC ABUSE SURVIVORS<sup>83</sup>

Many survivors of domestic abuse face dire situations, such as finding alternative housing in emergency situations. To reduce the financial burden associated with these emergencies, the SECURE 2.0 Act enables penalty-free distributions from eligible retirement accounts for victims of domestic abuse, even those under the age of 59½.

<sup>80</sup> SECURE 2.0 Act of 2022, PL 117-328, §126.

<sup>81</sup> Ibid, §325.

<sup>82</sup> IRS News Rel. IR-2022-188 (Oct. 21, 2022).

<sup>83</sup> SECURE 2.0 Act of 2022, PL 117-328, §314.

Participants can take penalty-free withdrawals to ease the financial burden of escaping an unsafe situation. Domestic abuse survivors can withdraw the lesser of \$10,000 or 50% of the vested account value. The distribution must be taken within 12 months from the date of abuse. The distribution is still taxable but is not subject to the 10% early withdrawal penalty. Taxpayers can repay the amount of the distribution over a 3-year period and then request a refund of the income tax paid.

**Note.** The \$10,000 withdrawal limit will be indexed for inflation.

A trustee does not need any formal legal complaint to distribute funds from retirement accounts. Instead, the taxpayer can self-certify that they have been a victim of domestic abuse. **Section 314 goes into effect beginning on January 1, 2024.**

## EMPLOYER CONTRIBUTIONS<sup>84</sup>

Section 604 of the SECURE 2.0 Act allows employers to treat matching or nonelective contributions as Roth contributions at the employee's election in some cases. These contributions are not excludable from income. Previously, employers were unable to provide matching Roth contributions to §401(k), §403(b), and §457(b) plans. Employers can now contribute Roth matches to these accounts under the provisions of §604.

## Tax-Free Withdrawals During Retirement

Before the enactment of the SECURE 2.0 Act, if an employee made contributions to their Roth §401(k), the employer matches were deposited in a traditional §401(k) account. When an employee retired or reached their RBD, distributions from their Roth account were not subject to tax, but distributions from their traditional §401(k) were taxable.

The employee must be fully vested in the Roth §401(k) so that the funds cannot be forfeited. If employers make Roth contributions to an employee's retirement account, the contributions must be included in that employee's wages and reported on their Form W-2, *Wage and Tax Statement*, for the tax year of the contribution. When the employee receives a distribution from their Roth account, the matching Roth contributions from the employer and the employee contributions will **both** be nontaxable.

## ROTH PLANS FOR SIMPLE AND SEP IRAS<sup>85</sup>

The SECURE 2.0 Act also enabled Roth plans for SIMPLE and SEP IRA plans, although the taxpayer must make an affirmative election to do so in both cases.<sup>86</sup> Until this provision of the SECURE 2.0 Act went into effect, business owners sometimes used contributions to SIMPLE and SEP plans to reduce taxable income. This calculation changes when making contributions to Roth SIMPLE or SEP IRA plans.

Taxpayers cannot exclude contributions to individual retirement plans designated as Roth IRAs under SEPs or SIMPLEs.<sup>87</sup> In addition, employees receiving employer contributions into their plans may expect an increase in income, as their employers' contributions are included in their taxable income. This is especially true if an election is made to treat the employer's matching or non-elective contributions as Roth contributions.<sup>88</sup>

<sup>84</sup> Ibid, §604.

<sup>85</sup> Ibid, §601, amending IRC §§402(h)(1), 402(h)(3), 408(k), 408(p), and 408A.

<sup>86</sup> IRC §§408(k)(7) and 408(p)(12).

<sup>87</sup> IRC §§402(h)(1)(C), 408(k)(7), and 408(p)(12).

<sup>88</sup> SECURE 2.0 Act of 2022, PL 117-328, §601, amending IRC §402A(a).

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The SECURE 2.0 Act changes do not explicitly exclude the application of the income limitation for Roth contributions.<sup>89</sup> Unless the IRS issues guidance to the contrary, if a client makes a Roth IRA contribution to an IRA that is not a Roth SEP or SIMPLE, and their income exceeds the contribution threshold, they may be assessed an **excess contribution penalty**.<sup>90</sup>

Contributions made in excess of the general or Roth IRA contribution limits are considered excess contributions and are subject to a 6% penalty,<sup>91</sup> which is reported on Form 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts*. This penalty cannot exceed 6% of the combined yearend value of all the taxpayer's IRAs. This penalty continues to apply each year to these excess contributions until the year they are withdrawn.<sup>92</sup>

The excess contribution to Roth IRAs is calculated as follows.

1. Current year contributions to Roth IRAs that are more than the Roth contribution limit for the year, plus
2. Any excess contributions for the preceding year, reduced by the total of:
  - a. Any Roth IRA distributions for the year, plus
  - b. The general contribution limit for the year less all IRA contributions for the year.

**Note.** More information on the excess contribution penalty and examples are in the 2018 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: Retirement Plans for Small Businesses. This can be found at [uofi.tax/arc](https://uofi.tax/arc) [[taxschool.illinois.edu/taxbookarchive](https://taxschool.illinois.edu/taxbookarchive)].

## SAVER'S MATCH

Section 103 of the SECURE 2.0 Act helps taxpayers save for retirement by introducing a matching contribution to the taxpayer's retirement account. Section 104 outlines that the promotion of the saver's match primarily focuses on low and moderate-income taxpayers. The American Retirement Association estimates nearly 108 million Americans will be eligible for this new initiative.<sup>93</sup>

## Changes Under SECURE 2.0 Act

Section 103 replaces the current nonrefundable **saver's credit** claimed on the individual tax return. Instead of reducing the taxpayer's tax liability like the saver's credit, the **saver's match** directs the Treasury to deposit funds directly into the taxpayer's IRA or retirement plan. The saver's match is equal to 50% of the first \$2,000 that a taxpayer contributes to an eligible plan and is subject to phase out, with the maximum benefit remaining the same as the saver's credit at \$1,000 per taxpayer.<sup>94</sup>

Eligible plans are all non-Roth retirement plans and includes employer deferred compensation plans under §§457(b), 401(k) plans, and 403(b) plans if they do not consist of a qualified Roth contribution program under IRC §402A(b).<sup>95</sup>

The following table compares the differences between the saver's credit and saver's match.

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<sup>89</sup> Ibid, §601.

<sup>90</sup> IRC §§4973(a) and (f).

<sup>91</sup> IRC §4973(a).

<sup>92</sup> IRC §4973(b).

<sup>93</sup> *ARA Applauds Sweeping New Retirement Security Legislation*. Dec. 20, 2022. American Retirement Association. [[www.usaretirement.org/ara-applauds-sweeping-new-retirement-security-legislation](https://www.usaretirement.org/ara-applauds-sweeping-new-retirement-security-legislation)] Accessed on Mar. 6, 2023.

<sup>94</sup> *SECURE 2.0 Act of 2022*, PL 117-328, §103.

<sup>95</sup> Ibid.

| Change                     | Saver's Credit (Old)                                                                        | Saver's Match (New)                                                                                    |
|----------------------------|---------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------|
| Eligible accounts          | Employer and IRAs                                                                           | Non-Roth IRAs                                                                                          |
| Payment method             | Nonrefundable credit on the individual tax return                                           | Deposited directly into the IRA                                                                        |
| Maximum credit             | \$1,000 per taxpayer                                                                        | \$1,000 per taxpayer                                                                                   |
| Early withdrawal penalties | Standard early retirement penalties                                                         | Standard early retirement penalties and possible repayment of match                                    |
| Calculating the credit     | 10%, 20%, or 50% of the first \$2,000 contributed to a retirement account (based on income) | 50% of the first \$2,000 contributed to a retirement account subject to phaseout for income thresholds |

## Year of Implementation

Unlike many of the provisions in the SECURE 2.0 Act, §103 does not go into effect until **2027**.<sup>96</sup> The phase-out thresholds and specifics of the credit can change by 2026. Section 104 mandates that the Treasury Secretary must outline the promotion efforts and specifics to Congress by July 1, 2026, six months before §103 goes into effect.<sup>97</sup>

## Limitations of the Saver's Match

The match has a low phase-out threshold, excluding a sizable portion of taxpayers. The modified adjusted gross income (MAGI) phase-out thresholds for years after December 31, 2026, are as follows.<sup>98</sup>

- Single: \$20,500–\$35,500
- Married filing separately (MFS): \$20,500–\$35,500
- Head of household (HoH): \$30,750–\$53,250
- Married filing jointly (MFJ): \$41,000–\$71,000

Withdrawing funds early can result in the required repayment of the saver's match and early withdrawal penalties. These consequences make this program a less viable option for taxpayers that frequently take IRA loans and distributions before reaching the eligible age.

Despite superseding the saver's credit, many of the same qualification criteria are present in the saver's match. This criterion includes the exclusion of taxpayers claimed as a dependent on another return, taxpayers that are students, and taxpayers under 18 years of age.<sup>99</sup> This makes it difficult for college students to develop good retirement habits while still in school.

**Example 12.** Jason is 21 years old and graduates from college in the spring of 2027. Jason is a single filer, and no other taxpayer claims him as a dependent. He works part-time at the coffee shop on his college campus and makes \$15,000 annually. Jason has recently learned the importance of planning for retirement early and has opened a traditional IRA, to which he plans on contributing \$2,000 per year.

Jason cannot take the saver's match in 2027. He was a full-time student for half the year and therefore does not qualify for the match.

<sup>96</sup> Ibid.

<sup>97</sup> Ibid, §104.

<sup>98</sup> Ibid, §103; IRC §6433(b)(2).

<sup>99</sup> *Retirement Savings Contributions Credit (Saver's Credit)*. Dec. 21, 2022. IRS. [www.irs.gov/retirement-plans/plan-participant-employee/retirement-savings-contributions-savers-credit] Accessed on Mar. 6, 2023.

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**Example 13.** Use the same facts as **Example 12**, except that Jason takes the next year off from school for travel. Jason takes the saver's match in 2028, assuming he has earned income and contributes \$2,000 to a traditional IRA. Because Jason is no longer a full-time student, is over 18 years old, and is under the MAGI threshold, he can receive a \$1,000 saver's match contribution.

## ROTH IRA UPDATE

Although taxpayers do not get a current tax deduction for contributions to Roth IRAs, the qualified distributions from Roth IRAs are not included in income. Taxpayers may contribute to Roth IRAs regardless of age, but the taxpayer must have earned income. High-income taxpayers (as defined by statute) are prohibited from contributing to Roth IRAs.<sup>100</sup>

Because qualified distributions from Roth IRAs are excluded from tax, they are attractive retirement planning vehicles for many taxpayers. This section examines methods for contributing funds into Roth IRA accounts either through new contributions, Roth conversions, backdoor conversions, or mega-backdoor conversions.

### CONTRIBUTIONS

The general contribution limit applies to all IRAs (traditional or Roth).<sup>101</sup> However, the Roth IRA contribution limit requires that a taxpayer first reduce the general contribution limit by any traditional IRA contributions made.<sup>102</sup> For 2023, the general contribution limit applicable to all of a taxpayer's traditional and Roth IRA contributions is the lesser of:

- \$6,500 (\$7,500 for taxpayers 50 or older before the end of the year),<sup>103</sup> or
- The taxpayer's taxable compensation for the year.

IRC §408A(c)(3) limits annual Roth IRA contributions based on a taxpayer's MAGI. Annually, the IRS issues a notice containing the cost-of-living adjustment<sup>104</sup> to the Roth IRA MAGI limit for all taxpayers. Taxpayers with incomes over the following phaseout ranges<sup>105</sup> cannot make Roth IRA contributions.

| Filing Status                                   | 2023 MAGI<br>Phaseout Ranges |
|-------------------------------------------------|------------------------------|
| Single, HoH                                     | \$138,000–153,000            |
| MFJ, Qualifying surviving spouse <sup>106</sup> | 218,000–228,000              |
| MFS (lived with spouse)                         | 0– 10,000                    |
| MFS (lived apart from spouse)                   | 138,000–153,000              |

<sup>100</sup>. IRC §408A(c)(3).

<sup>101</sup>. IRC §408A(c)(2).

<sup>102</sup>. Ibid.

<sup>103</sup>. IRS Notice 2022-55, 2022-45 IRB 443.

<sup>104</sup>. Ibid.

<sup>105</sup>. Ibid.

<sup>106</sup>. The filing status qualifying widow(er) is now called qualifying surviving spouse per IRS Pub. 17, *Your Federal Income Tax For Individuals* (2022). The rules for the filing status have not changed. The same rules that applied for qualifying widow(er) apply to qualifying surviving spouse.

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For purposes of a Roth IRA, MAGI is defined as follows.<sup>107</sup>

|                                                                                   |
|-----------------------------------------------------------------------------------|
| Adjusted gross income (AGI)                                                       |
| – Income resulting from the conversion of a traditional IRA to a Roth IRA         |
| – Income resulting from the rollover of a qualified retirement plan to a Roth IRA |
| + Traditional IRA deduction                                                       |
| + Student loan interest deduction                                                 |
| + Foreign-earned income exclusion and housing exclusion                           |
| + Foreign housing deduction                                                       |
| + Excludable qualified savings bond interest                                      |
| + Excluded employer-provided adoption benefits                                    |
| MAGI                                                                              |

Taxpayers with MAGI exceeding the phaseout ranges cannot make Roth IRA contributions. However, the age limit after which taxpayers can no longer contribute to IRAs no longer exists.<sup>108</sup>

**Example 14.** Shelly, a 49-year-old single filer with \$5,500 of 2023 taxable wages, would like to make a \$5,000 traditional IRA contribution and a \$2,000 Roth IRA contribution for 2023. Shelly's general contribution limit is \$5,500 (the lesser of compensation or \$6,500). If Shelly makes a \$5,000 traditional IRA contribution, her Roth IRA contribution limit is \$500 (\$5,500 general contribution limit – \$5,000 traditional IRA contribution). Therefore, Shelly can make only a \$500 Roth IRA contribution for 2023.

## Spousal Roth IRA

Married couples filing joint returns may facilitate a spouse's Roth IRA contribution by using the working spouse's compensation.<sup>109</sup> This requires that the couple file jointly and that MAGI is not over the phaseout range.<sup>110</sup> For 2023, the general contribution limit for a spousal IRA, either Roth or traditional, is the lesser of:<sup>111</sup>

- \$6,500 (\$7,500 for spouses ages 50 or over before the end of the year),<sup>112</sup> or
- The combined compensation of both spouses includable in gross income for the year, reduced by any IRA contributions (traditional or Roth) made by the other spouse for the year.

**Example 15.** On December 31, 2023, Tom and Betty are married taxpayers aged 73 and 69, respectively. During 2023, Tom receives only retirement income. Betty has \$5,000 taxable compensation. Tom makes a timely 2023 contribution to Betty's Roth IRA. Although Tom is over age 72, there is no maximum age for IRA contributions. However, the maximum contribution cannot exceed \$5,000 (Betty's taxable compensation).

**Example 16.** On December 31, 2023, Elena and Kevin Simpson are married taxpayers aged 46 and 49, respectively. Elena and Kevin have \$10,000 and \$5,000 of 2023 taxable compensation, respectively. Elena makes a \$6,500 timely 2023 contribution to her Roth IRA. Kevin would like to make the maximum 2023 contribution to his Roth IRA. Although the general contribution limit for Kevin is \$6,500, he only has \$5,000 of taxable 2023 compensation. Fortunately, Elena has \$3,500 (\$10,000 – \$6,500) of available taxable compensation that Kevin can use to facilitate the remaining \$1,500 of his \$6,500 Roth IRA contribution for 2023.

<sup>107</sup>. IRS Pub. 590-A, *Contributions to Individual Retirement Arrangements (IRAs)*.

<sup>108</sup>. *SECURE Act of 2019*, PL 116-94, §107, repealing IRC §§219(d)(1) and 408A(c)(4).

<sup>109</sup>. IRC §219(f)(2) defines compensation to include earned income and net earnings from self-employment in IRC §401(c)(2).

<sup>110</sup>. IRC §219(c)(2).

<sup>111</sup>. IRC §219(b)(1).

<sup>112</sup>. IRS Notice 2022-55, 2022-45 IRB 443.

## Excess Contributions

As mentioned previously, if a taxpayer makes a Roth IRA **contribution** that exceeds their contribution limit, the taxpayer may be subject to a 6% excess contribution penalty unless steps are taken to correct the excess.<sup>113</sup> A taxpayer has several options for correcting the excess contribution.

**Withdrawal of Excess Contribution.** If a taxpayer withdraws the excess contribution plus any earnings on the contribution prior to the due date (including extensions) of the individual income tax return, then the taxpayer is deemed to have not made a contribution at all for that tax year. The pitfall to this option is that the earnings that are withdrawn are taxable in the year the excess contribution was made not in the year received.<sup>114</sup> This means that the earnings should be reported on Form 1040, *U.S. Individual Income Tax Return*, for the deemed contribution year.

When a tax return with an IRA contribution is timely filed (excluding extensions), the IRA contribution can still be returned penalty-free within six months of the original due date.<sup>115</sup> In this case, the taxpayer should file an amended return with “Filed pursuant to section 301.9100-2” written at the top. Any related earnings should be reported on the amended return and an explanation of the withdrawal should be included.<sup>116</sup>

**Example 17.** Jan is in her early 30s and makes the maximum Roth IRA contribution of \$6,500 in June 2023 after receiving a big bonus. She is single with no children and only has one Form W-2 and a small dividend. Her Form W-2 reports taxable wages of \$150,000.

Jan makes an appointment with Keith, a local practitioner. His first available appointment is on April 1, 2024. Keith advises Jan about the income limitation associated with Roth IRA contributions and to withdraw the funds together with any earnings on the \$6,500. He explains that this needs to be done before the return is filed and that the earnings must be reported on the 2023 tax return. He also tells Jan that because she is under 59½, the earnings are subject to the 10% early withdrawal penalty tax. He recommends that Jan files an extension to have time to make the withdrawal. Once withdrawn, Jan lets Keith know the amount of earnings on the Roth IRA, and Keith reports the earnings on Jan’s Form 1040 for 2023.

**Example 18.** Use the same facts as **Example 17**. Jan files her 2023 tax return without making the withdrawal of the excess contribution. Jan still has until the extended due date for an individual tax return to withdraw the excess contribution with the earnings. However, now Jan must file an amended return for 2023 to report the earnings.

**Carry Forward the Excess Contribution.**<sup>117</sup> If a taxpayer has an excess contribution for a year, they have the option of applying the excess contribution to the next tax year. This presumes that the taxpayer knows that they have less than the maximum contributed for the carryforward year.

**Example 19.** Use the same facts as **Example 17**, except that Jan knows that the bonus she receives in 2023 is the result of a special project and has already been told not to expect such a large bonus in 2024. Without a bonus, Jan’s income is \$100,000. Based on that amount of MAGI, Jan can make a \$6,500 Roth IRA contribution for 2024 (lesser of \$6,500 maximum contribution and \$100,000 MAGI). Because she has not yet made a 2024 contribution, she elects to treat the 2023 contribution as a 2024 contribution.

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<sup>113</sup> IRC §7701(a)(37), referring to IRC §408(a) for IRAs and IRC §408(b) for individual retirement annuities.

<sup>114</sup> IRC §408(d)(4).

<sup>115</sup> Treas. Reg. §301.9100-2.

<sup>116</sup> IRS Pub. 590-A, *Contributions to Individual Retirement Arrangements (IRAs)*.

<sup>117</sup> Ibid.



**Recharacterize the Excess Contribution.**<sup>118</sup> The most efficient tax option is to recharacterize the contribution as a traditional IRA contribution. The contribution is nondeductible but recharacterization prevents the taxpayer from having to withdraw the contribution altogether. Recharacterization involves undoing the original contribution and moving the funds to a traditional IRA. Taxpayers have until the due date of their return, including any extensions filed, to recharacterize a Roth contribution.<sup>119</sup> This is done in a trustee-to-trustee transfer and includes any earnings on the excess contribution. Although there would be no taxable income with the recharacterization, Form 8606, *Nondeductible IRAs*, is required to report the nondeductible IRA contribution.

**Do Nothing.** The 6% excess contribution penalty discussed previously applies each year that the excess contribution remains in the Roth IRA. Therefore, a taxpayer incurs additional penalties if they choose to do nothing to correct the excess contribution.



## Practitioner Planning Tip

It is important that practitioners ask whether a taxpayer has made excess contributions to a Roth account as it may be necessary to extend the due date of the return in order to complete the recharacterization and correctly prepare the return.

## DISTRIBUTIONS<sup>120</sup>

Amounts that taxpayers distribute from their Roth IRA accounts follow a defined order.

1. Roth IRA contributions, excluding conversion contributions
2. Conversion contributions on a first-in, first-out basis
3. Earnings on contributions

**Note.** The reason the distribution order is important is if the taxpayer takes a distribution before the 5-year period ends, the earnings are taxable and subject to a penalty.<sup>121</sup>

This sequence has the fortunate consequence of classifying premature distributions as coming from regular contributions. Because the contributions already have a basis, the first distribution amounts are considered a return of the taxpayer's contributions<sup>122</sup> and are not included in gross income. Distributions deplete each category before they deplete the next in the order listed previously.

Taxpayers must aggregate all Roth distributions during the year as one distribution. Thus, any one distribution is considered to have been made from all of a taxpayer's Roth accounts collectively.<sup>123</sup>

<sup>118</sup>. Treas. Reg. §1.408A-5.

<sup>119</sup>. Ibid.

<sup>120</sup>. Treas. Reg. §1.408A-6, A-8.

<sup>121</sup>. IRC §408A (d)(B).

<sup>122</sup>. Treas. Reg. §1.408A-6, A-1(b), referencing A-8.

<sup>123</sup>. Treas. Reg. §1.408A-6, A-9.

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## ROTH CONVERSIONS

A Roth IRA is an attractive retirement planning strategy for many taxpayers because there are no RMD requirements during the life of the account owner. If qualified withdrawals are made, they are completely tax-free.<sup>124</sup> Converting traditional IRAs into Roth IRAs makes it possible to shield more of a taxpayer's retirement account from future tax. This can be a complex process, and tax professionals must be able to navigate the confusing rules regarding conversions to advise their clients properly.

### Taxpayers Benefiting from Roth Conversions

Not all taxpayers benefit from Roth conversions, regardless of their popularity. For most taxpayers, the strategy is converting a traditional IRA to a Roth IRA while realizing as little taxable income as possible. Having settled this, getting money out of the Roth IRA with as little tax as possible becomes paramount.

**Taxpayers Not Needing Distributions for Five Years After Conversion.**<sup>125</sup> Contributions to Roth IRAs must remain in place for at least five years until they can be withdrawn tax-free as a qualified distribution.<sup>126</sup> Known as the nonexclusion period, it begins on January 1, the first year the taxpayer makes a Roth contribution. When the taxpayer makes contributions in subsequent years, the nonexclusion period does not change.

The rule for **conversions** works differently. If a taxpayer is under age 59½, each conversion has its own 5-year period that must expire before the money associated with that conversion can be withdrawn without penalty. Consequently, taxpayers under age 59½ years may have an unpleasant surprise if a need arises for converted money within five years. They may incur an 10% additional tax under IRC §72(t) unless another exception to the penalty applies.

However, there are exceptions to the nonexclusion period, which enable the taxpayer to receive a **qualified special purpose distribution**.<sup>127</sup> These exceptions include the taxpayer becoming disabled, separating from their employer, receiving distributions that are part of a series of substantially equal periodic payments, among others.<sup>128</sup>



### Practitioner Planning Tip

While custodians should report these amounts with distribution code 2 on Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, they may report it with code 1 because they are unaware that an exception exists.<sup>129</sup> Practitioners should follow up with their clients to ensure that no exclusions apply.

<sup>124</sup>. The provision for tax-free withdrawals is subject to the 5-year nonexclusion period in IRC §408A(d)(2)(B).

<sup>125</sup>. Treas. Reg. §1.480A-6, A-5.

<sup>126</sup>. IRC §408A(d)(2)(B).

<sup>127</sup>. IRC §408A(d)(2)(A)(iv) and (t)(5), referring to IRC §72(t)(2).

<sup>128</sup>. IRC §72(t)(2).

<sup>129</sup>. Instructions for Forms 1099-R and 5498.

**Example 20.** Jeff is the account owner of a Roth IRA that had a value of \$76,000 on December 31, 2022. The funds in this Roth IRA were converted from a traditional IRA with a \$0 basis in 2020. Jeff turned 59 in January 2023.

Jeff needs money from his Roth IRA in November 2023, and none of the exceptions that could result in a qualified special purpose distribution apply. Although his 59th birthday occurred more than six months earlier, Jeff is still liable for tax on any portion of the Roth IRA conversion that he withdraws that year. The 5-year nonexclusion period during which he is still liable for the 10% penalty began on January 1, 2020, but does not expire until the last day of 2024.

**Taxpayers With Traditional IRAs Having Basis.** Ownership of a traditional IRA can trigger significant tax, even if the funds from an IRA with a 100% basis are used for the conversion. The rules for conversions assume that distributions are taken proportionately from each IRA an individual owns, regardless of the IRA from which the funds for the conversion come.<sup>130</sup>

## No Income Limit on Roth IRA Conversions

One of the advantages of converting traditional IRA accounts to Roth IRAs is that there is no income limit on conversions.<sup>131</sup> This is true even if a taxpayer's MAGI precludes a current-year contribution to a Roth IRA.

## Aggregate All IRAs

When determining the tax consequences of an IRA distribution, the IRS requires a pro rata distribution from **all** traditional IRA accounts.<sup>132</sup> This provision has the effect of requiring a taxpayer to aggregate the value of all IRA accounts. This can create unexpected tax consequences when a taxpayer has made both deductible and nondeductible contributions to an IRA. Because the IRAs are treated on an aggregate basis, each distribution includes only a partial basis recovery until all the basis has been recovered. If a taxpayer has multiple IRA accounts with a varying amount of basis, a conversion to a Roth IRA may be subject to additional taxes and possibly penalties.

Custodians or trustees of IRAs, including traditional, SIMPLE, SEP, and Roth IRA plans, report year-end values of accounts, as well as contributions, on Form 5498, *IRA Contribution Information*.<sup>133</sup> This information is valuable in determining the existence of accounts and their values as used to determine RMDs, if any. Custodians or trustees of IRAs are required to report this information on an annual basis to the IRS, which reports this information on wage and income transcripts.<sup>134</sup>

**Example 21.** Howard's income has increased substantially over his career. Although he started at one employer many years earlier at minimum wage, his income in 2023 at his second employer was too high for a single taxpayer to make deductible IRA contributions. Howard has actively contributed to a traditional IRA for the last five years, even though he was not able to deduct the contributions. By September 2023, Howard has built a traditional IRA with a significant basis and market value.

Shirley, Howard's new financial planner, knows the benefits of Roth IRAs and the tax ramifications of converting traditional IRAs to Roth IRAs. She also knows that converting a traditional IRA with a substantial basis can result in less tax. Reviewing Howard's tax returns for those five years, she confirms that Howard's basis in the IRA is \$29,500, while the market's rise puts the value of the IRA at \$40,000. Howard has forgotten about the SEP IRA from his first employer.

<sup>130</sup>. IRC §408(d)(2)(A).

<sup>131</sup>. IRC §408A(d)(3) provides for conversion but is not subject to the income limits of IRC §480A(d)(2), which apply only to contributions.

<sup>132</sup>. IRC §408(d)(2)(A).

<sup>133</sup>. Instructions for Forms 1099-R and 5498.

<sup>134</sup>. IRM 21.2.3.2.3 (2013).

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In October 2023, Howard converts his entire traditional IRA into a Roth IRA, thinking he added only \$10,500 to his total income (\$40,000 total market value – \$29,500 basis). Norma, Howard’s new tax practitioner, obtains his 2022 wage and income transcript from the IRS in November in preparation for the upcoming tax season. The appearance of a SEP IRA with a \$50,000 market value catches her attention, and she asks Howard about it. The custodian of the SEP IRA has reported its December 31, 2022, value on Form 5498, which the IRS records on Howard’s annual wage and income transcript. Her phone call reminds Howard about the account, which has not crossed his mind in a decade. Unfortunately, Norma has to tell Howard that his Roth conversion generates more taxable income than he had been anticipating. Even though the conversion itself only touches the traditional IRA account with a substantial basis, the conversion must also consider the SEP that Howard had forgotten about, which had a zero basis.



## Practitioner Planning Tip

If the taxpayer has SIMPLE or SEP IRAs without any basis as well as traditional IRAs with basis, a strategy might be to roll those SIMPLE or SEP IRAs into qualified employer plans **before** the Roth conversion. This will limit the taxability of the Roth conversion. However, the strategy will only be viable if the taxpayer is an active participant in such a plan, and the plan documents permit such transactions.

## Reporting Roth Conversions<sup>135</sup>

IRA trustees and custodians are required to report contributions in box 1 of Form 5498. This form denotes these as contributions to a Roth IRA by marking the appropriate checkbox in line 7. The account’s fair market value as of the last day of the prior year should appear in box 5. If the taxpayer makes any of the contributions for 2023 between January 1 and April 15, 2024, this amount should appear in box 10.

Form 5498 can also serve as a useful source of information about IRA conversions, as well, because box 3 reports the amount of Roth IRA conversions.



## Practitioner Planning Tip

Tax practitioners should consider reviewing at least five years of IRS wage and income transcripts for **new clients**. This information may provide important information regarding the 5-year nonexclusion periods for the clients’ Roth IRA contributions and the separate 5-year periods for their Roth conversions. This review may require new clients to execute Form 8821, *Tax Information Authorization*, or Form 2848, *Power of Attorney and Declaration of Representative*, so that the records can be obtained directly from the IRS.

<sup>135</sup>. Instructions for Forms 1099-R and 5498 (2023).

## Consequences of Conversions

Roth conversions have consequences that affect taxpayers' tax and financial positions. Some of those consequences are discussed next.

**Higher Taxes in Year of Conversion.** As mentioned previously, the amount converted to a Roth IRA in excess of any basis in the IRA is subject to income tax in the year of the conversion. The increased income can result in higher taxes for the taxpayer.

**Smaller Medical Deductions.** If a taxpayer itemizes, a Roth conversion likely increases their AGI, decreasing their itemized medical deductions.<sup>136</sup>

**Adjustments to Medicare Premiums in Future Years.**<sup>137</sup> The income generated from a Roth IRA conversion can also result in higher Medicare premiums in future years. This unwelcome premium increase has an official name: the income-related monthly adjustment amount (IRMAA).



### Practitioner Planning Tip

Tax practitioners with clients turning age 63 in the next year may choose to discuss with them the possibility that a Roth conversion may push the client into a higher Medicare premium bracket. For more information on IRMAA planning, see the 2022 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 1: Elder Issues.

**Net Investment Income Tax (NIIT).** If a taxpayer converts a traditional IRA to a Roth IRA and the conversion increases their MAGI over the net investment income threshold, they may be subject to NIIT on their dividends, interest, and other net investment income.<sup>138</sup>

In the case of an individual, the NIIT is 3.8% on the lesser of:<sup>139</sup>

- Net investment income, or
- The excess of MAGI over the following threshold amounts:
  - ♦ \$250,000 for MFJ or qualifying surviving spouse
  - ♦ \$125,000 for MFS
  - ♦ \$200,000 for single or HoH

<sup>136</sup>. See IRC §213.

<sup>137</sup>. *Premiums: Rules for Higher-Income Beneficiaries*. 2023. SSA. [[www.ssa.gov/benefits/medicare/medicare-premiums.html](http://www.ssa.gov/benefits/medicare/medicare-premiums.html)] Accessed on Jun. 22, 2023.

<sup>138</sup>. IRC §1411.

<sup>139</sup>. *Topic No. 559, Net Investment Income Tax*. Apr. 6, 2023. IRS. [[www.irs.gov/taxtopics/tc559](http://www.irs.gov/taxtopics/tc559)] Accessed on Jul. 20, 2023.

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**Example 22.** Alex is a junior manager for a large manufacturing firm, which pays him a taxable salary of \$110,000 annually. As a single taxpayer, Alex has accumulated a significant traditional IRA from his early days with the firm in 2003. He has no basis in the IRA, as he made only tax-deductible contributions.

In 2022, Alex's Aunt Martha passes away, leaving him with a substantial inheritance consisting of dividend-paying stocks. In early January 2023, Aunt Martha's executor transfers the stock into Alex's name. Stella is Alex's financial planner, and she tells him to anticipate dividend income for 2023 of \$80,000 from his inheritance. Alex's projected MAGI for 2023 is \$190,000 (\$110,000 salary + \$80,000 dividend income). Stella informs Alex that although he can expect his tax to increase, he can be thankful that it is unlikely to cause an NIIT problem.

Stella is also aware of Alex's IRA and for the last several years has been discussing with him the possibility of converting it to a Roth IRA. At their yearend meeting in December 2022, Stella advises Alex that if he waits until 2023 to make the Roth IRA conversion, he may have NIIT because a Roth conversion would leave him with 2023 projected income exceeding the NIIT threshold.

Alex has a tax planning opportunity. He can convert some portion of his traditional IRA into a Roth IRA in the waning days of 2022 and be less likely to have a NIIT liability. Alternatively, he can wait until 2023 when the conversion likely creates a larger tax burden because of the combined effect of the dividend income and the NIIT. The threshold for the NIIT is not indexed, so Alex is unlikely to see his income drop below the threshold until he retires.

## Recharacterization of Roth Conversions<sup>140</sup>

Before December 31, 2017, a taxpayer could convert from a Roth account back to a traditional IRA. After the Tax Cuts and Jobs Act<sup>141</sup> (TCJA), undoing a conversion is no longer permitted. The Code also prohibits recharacterizing amounts a taxpayer has converted from one of the following types of qualified retirement plans.

- Traditional, SEP, or SIMPLE IRAs
- IRC §401(k) plans
- IRC §§403(b) or 457 plans

If a taxpayer ends the year with a higher-than-expected taxable income, reversing the situation is impossible.

## BACKDOOR ROTH CONVERSIONS

The Code contains MAGI limitations on contributions to Roth IRAs,<sup>142</sup> but it does not limit conversions and rollovers based on MAGI. This provision allows individuals to contribute to nondeductible traditional IRAs and convert the traditional IRA to a Roth IRA. This maneuver, often called a "backdoor Roth," only works well if the taxpayer does not have any other traditional IRAs because the portion of IRA distributions treated as a return of nondeductible contributions is prorated based on the total balance of the IRAs per the aggregation rule discussed previously.<sup>143</sup>

**Note.** The total balance of the IRAs must be modified for amounts distributed and outstanding rollovers. Complete instructions for calculating the nontaxable portion of traditional IRA distributions when the taxpayer has basis are found in the instructions for Form 8606.

<sup>140</sup>. IRC §408A(d)(6)(B)(iii). See also *IRA FAQs - Recharacterization of IRA Contributions*. Jan. 15, 2020. IRS. [www.irs.gov/retirement-plans/retirement-plans-faqs-regarding-iras] Accessed on Jun. 22, 2023.

<sup>141</sup>. *Tax Cuts and Jobs Act*, PL 115-97.

<sup>142</sup>. IRC §408A(c)(3).

<sup>143</sup>. IRS Notice 87-16, 1987-1 CB 446.

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**Example 23.** Ethan is a senior manager at a manufacturing company but did not have any traditional or Roth IRAs in 2021, the year he turned 56 years old. In 2022, his MAGI was \$230,000, which was over the applicable Roth IRA contribution limit. Accordingly, he is not permitted to contribute directly to a Roth IRA.

Instead, Ethan contributes \$6,000 to a traditional IRA for 2022 in early December of that year. Because Ethan is covered by a retirement plan with his employer, his MAGI is too high to deduct the traditional IRA contribution. On his 2022 return, he completes Form 8606 to establish a \$6,000 basis in his traditional IRA.

After contributing the \$6,000, Ethan converts the traditional IRA to a Roth IRA in mid-December 2022. The financial institution holding the funds issues a Form 1099-R for 2022, showing that Ethan received a \$6,000 distribution from his traditional IRA. Ethan reports the distribution on his return and includes the distribution on Form 8606 to reduce the taxable portion of the \$6,000 distribution by his \$6,000 basis. The result is that Ethan could add \$6,000 to a Roth IRA for 2022 without tax consequences despite his income being over the applicable limits.

The strategy loses its appeal if the taxpayer has a traditional IRA with little or no basis. In this event, a substantial portion of the backdoor IRA becomes taxable.

**Example 24.** Use the same facts as **Example 23**, except Ethan has \$76,000 in traditional IRAs as of December 31, 2022, funded when his MAGI was low enough to make deductible contributions. Starting in 2003, Ethan made these contributions with no basis in his traditional IRAs and stopped in 2013 when his income increased to the point he could no longer make contributions.

When Ethan makes the contribution of \$6,000 in 2022, he sets up a new traditional IRA for his nondeductible contribution. Ethan is thinking that he can specifically identify that account as the account that he is converting to a Roth IRA. However, this is not effective because the basis created by the 2022 contribution is applied to his aggregated traditional IRAs. Accordingly, \$5,561 of the distribution is taxable, as shown on the following Worksheet 1-1 from IRS Pub. 590-B. Ethan's 2022 Form 8606 follows the worksheet.

|                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |                  |              |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------|--------------|
| 1. Enter the basis in your traditional IRAs as of December 31, 2021 .....                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      | 1. _____         | 0            |
| 2. Enter the total of all contributions made to your traditional IRAs during 2022 and all contributions made during 2023 that were for 2022, <b>whether or not deductible</b> . Don't include rollover contributions properly rolled over into IRAs. Also, don't include certain returned contributions described in the instructions for line 7 of Form 8606 .....                                                                                                                                                                                                                            | 2. _____         | 6,000        |
| 3. Add lines 1 and 2 .....                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     | 3. _____         | 6,000        |
| 4. Enter the value of all your traditional IRAs as of December 31, 2022 (include any outstanding rollovers from traditional IRAs to other traditional IRAs). Subtract any repayments of qualified disaster distributions .....                                                                                                                                                                                                                                                                                                                                                                 | 4. _____         | 76,000       |
| 5. Enter the total distributions from traditional IRAs (including amounts converted to Roth IRAs that will be shown on line 16 of Form 8606) received in 2022. Also, include repayments of qualified disaster distributions, qualified charitable distributions (QCDs), and a one-time distribution to fund a health savings account (HSA). (Don't include outstanding rollovers included on line 4 or any rollovers between traditional IRAs completed by December 31, 2022. Also, don't include certain returned contributions described in the instructions for line 7 of Form 8606.) ..... | 5. _____         | 6,000        |
| 6. Add lines 4 and 5 .....                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     | 6. _____         | 82,000       |
| 7. Divide line 3 by line 6. Enter the result as a decimal (rounded to at least three places). If the result is 1.000 or more, enter 1.000 .....                                                                                                                                                                                                                                                                                                                                                                                                                                                | 7. _____         | 0.07317      |
| <b>8. Nontaxable portion of the distribution.</b><br>Multiply line 5 by line 7. Enter the result here and on lines 13 and 17 of Form 8606 .....                                                                                                                                                                                                                                                                                                                                                                                                                                                | 8. _____         | 439          |
| <b>9. Taxable portion of the distribution (before adjustment for conversions).</b><br>Subtract line 8 from line 5. Enter the result here, and if there are no amounts converted to Roth IRAs, <b>stop here</b> and enter the result on line 15a of Form 8606 .....                                                                                                                                                                                                                                                                                                                             | 9. _____         | 5,561        |
| <b>10. Enter the amount included on line 9 that is allocable to amounts converted to Roth IRAs by December 31, 2022. (See <b>Note</b> at the end of this worksheet.) Enter here and on line 18 of Form 8606 .....</b>                                                                                                                                                                                                                                                                                                                                                                          | <b>10. _____</b> | <b>5,561</b> |
| <b>11. Taxable portion of the distribution (after adjustments for conversions).</b><br>Subtract line 10 from line 9. Enter the result here and on line 15a of Form 8606 .....                                                                                                                                                                                                                                                                                                                                                                                                                  | <b>11. _____</b> |              |

**Note.** If the amount on line 5 of this worksheet includes an amount converted to a Roth IRA by December 31, 2022, you must determine the percentage of the distribution allocable to the conversion. To figure the percentage, divide the amount converted (from line 16 of Form 8606) by the total distributions shown on line 5. To figure the amounts to include on line 10 of this worksheet and on line 18 of Form 8606, multiply line 9 of the worksheet by the percentage you figured.

# 2023 Workbook

## For Example 24

|                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                 |                                                                                                                                                                                                   |                                                                                                                                           |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------|
| Form <b>8606</b><br>Department of the Treasury<br>Internal Revenue Service                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      | <b>Nondeductible IRAs</b><br>Go to <a href="https://www.irs.gov/Form8606">www.irs.gov/Form8606</a> for instructions and the latest information.<br>Attach to 2022 Form 1040, 1040-SR, or 1040-NR. | OMB No. 1545-0074<br><div style="text-align: center; font-size: 24pt; font-weight: bold;">2022</div> Attachment<br>Sequence No. <b>48</b> |
| Name. If married, file a separate form for each spouse required to file 2022 Form 8606. See instructions.<br><b>Ethan Miller</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |                                                                                                                                                                                                   | Your social security number<br><b>***-**-9999</b>                                                                                         |
| <b>Fill in Your Address Only if You Are Filing This Form by Itself and Not With Your Tax Return</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             | Home address (number and street, or P.O. box if mail is not delivered to your home)<br><b>101 S. Vermont St</b>                                                                                   |                                                                                                                                           |
|                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                 | City, town or post office, state, and ZIP code. If you have a foreign address, also complete the spaces below (see instructions).<br><b>Burlington, IL 60109</b>                                  |                                                                                                                                           |
|                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                 | Foreign country name                                                                                                                                                                              | Foreign province/state/county                                                                                                             |
|                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                 | Foreign postal code                                                                                                                                                                               |                                                                                                                                           |
| <b>Part I Nondeductible Contributions to Traditional IRAs and Distributions From Traditional, SEP, and SIMPLE IRAs</b><br>Complete this part only if one or more of the following apply.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                        |                                                                                                                                                                                                   |                                                                                                                                           |
| <ul style="list-style-type: none"> <li>You made nondeductible contributions to a traditional IRA for 2022.</li> <li>You took distributions from a traditional, SEP, or SIMPLE IRA in 2022 and you made nondeductible contributions to a traditional IRA in 2022 or an earlier year. For this purpose, a distribution does not include a rollover (other than a repayment of a qualified disaster distribution, if any, from 2022 Form(s) 8915-F (see instructions)), qualified charitable distribution, one-time distribution to fund an HSA, conversion, recharacterization, or return of certain contributions.</li> <li>You converted part, but not all, of your traditional, SEP, and SIMPLE IRAs to Roth IRAs in 2022 and you made nondeductible contributions to a traditional IRA in 2022 or an earlier year.</li> </ul> |                                                                                                                                                                                                   |                                                                                                                                           |
| <b>1</b> Enter your nondeductible contributions to traditional IRAs for 2022, including those made for 2022 from January 1, 2023, through April 18, 2023. See instructions . . . . .                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                            | <b>1</b> <b>6,000</b>                                                                                                                                                                             |                                                                                                                                           |
| <b>2</b> Enter your total basis in traditional IRAs. See instructions . . . . .                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                 | <b>2</b>                                                                                                                                                                                          |                                                                                                                                           |
| <b>3</b> Add lines 1 and 2 . . . . .                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                            | <b>3</b> <b>6,000</b>                                                                                                                                                                             |                                                                                                                                           |
| <div style="border: 1px solid black; padding: 5px; display: inline-block;"> <b>In 2022, did you take a distribution from traditional, SEP, or SIMPLE IRAs, or make a Roth IRA conversion?</b> </div> <b>No</b> Enter the amount from line 3 on line 14. Do not complete the rest of Part I.<br><b>Yes</b> Go to line 4.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |                                                                                                                                                                                                   |                                                                                                                                           |
| <b>4</b> Enter those contributions included on line 1 that were made from January 1, 2023, through April 18, 2023                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                               | <b>4</b>                                                                                                                                                                                          |                                                                                                                                           |
| <b>5</b> Subtract line 4 from line 3 . . . . .                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  | <b>5</b> <b>6,000</b>                                                                                                                                                                             |                                                                                                                                           |
| <b>6</b> Enter the value of <b>all</b> your traditional, SEP, and SIMPLE IRAs as of December 31, 2022, plus any outstanding rollovers. Subtract certain repayments of qualified disaster distributions, if any, from 2022 Form(s) 8915-F (see instructions) . .                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                 | <b>6</b> <b>76,000</b>                                                                                                                                                                            |                                                                                                                                           |
| <b>7</b> Enter your distributions from traditional, SEP, and SIMPLE IRAs in 2022. <b>Do not</b> include rollovers (other than repayments of qualified disaster distributions, if any, from 2022 Form(s) 8915-F (see instructions)), 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) . . . . .                                                                                                                                                                                                                                                                                                                                                                 | <b>7</b>                                                                                                                                                                                          |                                                                                                                                           |
| <b>8</b> Enter the net amount you converted from traditional, SEP, and SIMPLE IRAs to Roth IRAs in 2022. Also, enter this amount on line 16 . . . . .                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           | <b>8</b> <b>6,000</b>                                                                                                                                                                             |                                                                                                                                           |
| <b>9</b> Add lines 6, 7, and 8 . . . . .                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                        | <b>9</b> <b>82,000</b>                                                                                                                                                                            |                                                                                                                                           |
| <b>10</b> 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" . . . . .                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                          | <b>10</b> <b>× 0.0732</b>                                                                                                                                                                         |                                                                                                                                           |
| <b>11</b> 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 . . . . .                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     | <b>11</b> <b>439</b>                                                                                                                                                                              |                                                                                                                                           |
| <b>12</b> Multiply line 7 by line 10. This is the nontaxable portion of your distributions that you did not convert to a Roth IRA . . . . .                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     | <b>12</b>                                                                                                                                                                                         |                                                                                                                                           |
| <b>13</b> Add lines 11 and 12. This is the nontaxable portion of all your distributions . . . . .                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                               | <b>13</b> <b>439</b>                                                                                                                                                                              |                                                                                                                                           |
| <b>14</b> Subtract line 13 from line 3. This is <b>your total basis in traditional IRAs for 2022 and earlier years</b> . . . . .                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                | <b>14</b> <b>5,561</b>                                                                                                                                                                            |                                                                                                                                           |
| <b>15a</b> Subtract line 12 from line 7 . . . . .                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                               | <b>15a</b>                                                                                                                                                                                        |                                                                                                                                           |
| <b>b</b> Enter the amount on line 15a attributable to qualified disaster distributions, if any, from 2022 Form(s) 8915-F (see instructions). Also, enter this amount on 2022 Form(s) 8915-F, line 18, as applicable (see instructions) . . . . .                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                | <b>15b</b>                                                                                                                                                                                        |                                                                                                                                           |
| <b>c Taxable amount.</b> Subtract line 15b from line 15a. If more than zero, also include this amount on 2022 Form 1040, 1040-SR, or 1040-NR, line 4b . . . . .<br><b>Note:</b> You may be subject to an additional 10% tax on the amount on line 15c if you were under age 59½ at the time of the distribution. See instructions.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                              | <b>15c</b>                                                                                                                                                                                        |                                                                                                                                           |

For Privacy Act and Paperwork Reduction Act Notice, see separate instructions.

Cat. No. 63966F

Form **8606** (2022)



# 2023 Workbook

## For Example 24

Form 8606 (2022)

Page **2**

### Part II 2022 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 2022.

|           |                                                                                                                                                                            |           |              |
|-----------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------|--------------|
| <b>16</b> | 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 2022 . . . . . | <b>16</b> | <b>6,000</b> |
| <b>17</b> | If you completed Part I, enter the amount from line 11. Otherwise, enter your basis in the amount on line 16 (see instructions) . . . . .                                  | <b>17</b> | <b>439</b>   |
| <b>18</b> | <b>Taxable amount.</b> Subtract line 17 from line 16. If more than zero, also include this amount on 2022 Form 1040, 1040-SR, or 1040-NR, line 4b . . . . .                | <b>18</b> | <b>5,561</b> |

### Distributions From Roth IRAs

As a result, very little of the basis from Ethan's 2022 nondeductible traditional IRA contribution is included in the basis of the Roth conversion. If Ethan realizes this after he has made the conversion and has second thoughts, he cannot undo the conversion.

## Other Concerns

The IRS has not explicitly sanctioned any form of backdoor Roth conversion. Some speculate that the step transaction doctrine could be used to conclude that an attempted Roth conversion is not legitimate for an individual otherwise ineligible to make a Roth **contribution** because of their income.<sup>144</sup> The step transaction doctrine combines a series of actions into a single transaction if the series of actions seem to be directed to accomplish a particular result.<sup>145</sup>

In a 1987 case, the Tax Court used the step transaction doctrine to decide that a corporate reorganization was tax-deferred in light of its acquisition. The court offered the following logic.<sup>146</sup>

*The step transaction doctrine is in effect another rule of substance over form; it treats a series of formally separate "steps" as a single transaction if such steps are in substance integrated, interdependent, and focused toward a particular result... There is no universally accepted test as to when and how the step transaction doctrine should be applied to a given set of facts.*

The House Conference Report on TCJA discusses Roth conversions, acknowledging in a footnote that taxpayers with incomes exceeding the Roth IRA contribution threshold may convert funds from traditional IRAs into Roth accounts.<sup>147</sup> A footnote in a report may indicate Congressional intent, but it does not carry the same weight as the enacted statute.

**Caution.** Absent any guidance from the IRS on this point, taxpayers and their tax practitioners must understand the risk associated with backdoor Roth IRA conversions. Although not enacted, legislation has been suggested that could restrict Roth conversions by income.<sup>148</sup>

**Note.** Although Treas. Reg. §1.408A-4, answer 2, still states that a conversion is not permitted for individuals with MAGI exceeding \$100,000, this is no longer correct. It was overturned by the *Tax Increase Prevention and Reconciliation Act of 2005*, PL 109-222, §512(a). Although this law was enacted in 2006, the IRS has not removed this from the regulation.

<sup>144</sup>. *Backdoor Roth IRA Contributions — Strategy or Step Transaction Abuse?* Kitces, Michael. Jan. 24, 2012. Kitces.com. [www.kitces.com/blog/dodging-the-income-limits-on-roth-contributions-strategy-or-abuse] Accessed on Jun. 28, 2023.

<sup>145</sup>. *A walk through the step-transaction doctrine.* Knight, Ray and Knight, Lee. May 1, 2021. The Tax Adviser. [www.thetaxadviser.com/issues/2021/may/step-transaction-doctrine.html] Accessed on Jun. 27, 2023.

<sup>146</sup>. *Penrod, et al. v. Comm'r*, 88 TC 1415 (1987).

<sup>147</sup>. H.R. Rep. No. 115-466, at 289 (2017).

<sup>148</sup>. *Fact Sheet: The President's Budget Cuts Wasteful Spending on Big Pharma, Big Oil, and Other Special Interests, Cracks Down on Systemic Fraud, and Makes Programs More Cost Effective.* Mar. 9, 2023. The White House. [www.whitehouse.gov/briefing-room/statements-releases/2023/03/09/fact-sheet-the-presidents-budget-cuts-wasteful-spending-on-big-pharma-big-oil-and-other-special-interests-cracks-down-on-systemic-fraud-and-makes-programs-more-cost-effective] Accessed on Jun. 27, 2023.

## MEGA-BACKDOOR ROTH CONVERSIONS<sup>149</sup>

Some taxpayers may wish to accumulate retirement funds in Roth accounts even faster. The “mega-backdoor” Roth conversion strategy allows high-income taxpayers to accumulate more wealth in Roth IRAs despite the MAGI limitations discussed previously.

This special mega-backdoor Roth conversion requires several factors to work.

- The taxpayer must have a §401(k) or §403(b) plan to which they can contribute, and the plan must offer a Roth contribution option. The conversion works even better if the plan allows additional after-tax contributions.
- The plan documents must permit the conversion of previously made contributions to Roth contributions; alternatively, the plan must allow participants to make withdrawals while still participating in the plan.

Contributions to §401(k) plans generally are subject to certain limits.<sup>150</sup>

1. IRC §402(g) limits an employee’s salary deferrals (\$22,500 in 2023), although this limit itself is increased under IRC §414(v) for individuals at least age 50. It is increased another \$7,500 in 2023 to a \$30,000 maximum elective deferral.<sup>151</sup> This is the **elective deferral limit**.
2. IRC §415(c) imposes an annual ceiling on total contributions, which is the lesser of the employee’s compensation or an annual limit. In 2023, this limit is \$66,000<sup>152</sup> for those under 50 (\$73,500 for individuals over age 50).<sup>153</sup> This is the annual **additions limit**.<sup>154</sup>

**Note.** The Code imposes a reduced limit on individuals whom it classifies as highly compensated employees or key employees,<sup>155</sup> as the organization needs the lower limit to meet a nondiscrimination test.<sup>156</sup> If an adjustment is needed under this test, then highly compensated individuals are refunded a portion of the money they set aside as elective deferrals in most cases.

Frequently, a §401(k) plan offers employees the option of contributing on an after-tax basis up to the maximum annual limitation. Because these additional contributions are made with after-tax dollars, these amounts are not taxable when withdrawn. If the employee is now able to convert these after-tax contributions into Roth contributions within the §401(k) plan, it may be possible for them to fund a Roth with a significant amount of money.

**Example 25.** Marcy is a single taxpayer. Her employer, Anatine Corporation, has §401(k) plans that allow elective deferrals as Roth contributions. In 2023, Marcy is 55 years old, qualifying her to make catch-up contributions to the retirement plan. Anatine matches her contributions at the rate of 8%. Marcy’s salary and bonus for 2023 is \$185,000 so her MAGI would prevent her from making a Roth contribution individually. However, Marcy can still participate in the Roth option allowed by Anatine’s §401(k) plan.

Marcy’s maximum §401(k) elective deferral is \$30,000, consisting of a \$22,500 maximum deferral for all covered employees plus a \$7,500 catch-up contribution. If she makes her maximum elective deferral, Anatine contributes another \$2,400 (\$30,000 × 8%). Marcy can contribute up to \$41,100 in after-tax contributions before reaching her annual limit. This is computed by reducing her annual limit of \$73,500 by her \$30,000 of elective deferrals and by the \$2,400 employer’s match. If all these funds are contributed to the Roth IRA, Marcy is able to put \$73,500 into a Roth account, well beyond the \$7,500 individual limit for a Roth IRA.

<sup>149</sup>. *How the mega-backdoor Roth works*. Long, Kelley. May 9, 2023. Journal of Accountancy. [www.journalofaccountancy.com/news/2023/may/how-mega-backdoor-roth-works.html] Accessed on Jun. 26, 2023.

<sup>150</sup>. *401(k) Contribution Limits — What You Need to Know*. Droblyen, Eric. Jun. 15, 2023. Employee Fiduciary. [www.employeefiduciary.com/blog/contribution-limits] Accessed on Jul. 19, 2023.

<sup>151</sup>. IRS Notice 2022-55, 2022-45 IRB 443.

<sup>152</sup>. Ibid. Any catch-up contributions are not included in the annual addition limit.

<sup>153</sup>. *Retirement Topics — 401(k) and Profit-Sharing Plan Contribution Limits*. Aug. 29, 2023. IRS. [www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-401k-and-profit-sharing-plan-contribution-limits] Accessed on Aug. 29, 2023.

<sup>154</sup>. IRC §415(c)(2).

<sup>155</sup>. IRC §414(q) or 416(i)(1).

<sup>156</sup>. IRC §401(m).