

Elder Client PLANNER

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Backdoor Roth strategy may backfire

TAX: High-income taxpayers who contribute to a nondeductible IRA and then convert to a Roth may draw IRS ire.

By Tim Hilger, CPA

Editor

A subscriber recently contacted us with a client story. His client was over the income limit for contributing to a Roth, so he used the contribute/convert strategy. In that strategy, the taxpayer contributes to a nondeductible IRA (no income limit) and then converts it to a Roth (no income limit).

The subscriber said that the IRS was invalidating the transaction without saying why. It seems most likely that the IRS was using the step transaction doctrine. If so, the result would be that the two steps were deemed collapsed into one — a direct contribution to a Roth. The end result is an excess contributions penalty of 6% of the contribution, which would continue each year until the funds were withdrawn from the account.

The backdoor Roth strategy

Under the Tax Increase Prevention and Reconciliation Act of 2005, the AGI limitation that prevented many taxpayers from converting traditional IRAs to Roth IRAs was eliminated effective in the 2010 taxable year.¹

However, the AGI limitations on making Roth contributions remained intact. Nonetheless, there appeared to be nothing to prevent a taxpayer from making a contribution to a nondeductible IRA and then immediately converting it to a Roth.

While this strategy was no secret, it wasn't well known. However, its popularity increased substantially when Forbes ran an article in January 2012 extolling the virtues of the strategy.²

In conclusion

What we know at this point is hearsay; the IRS has not issued anything official. If a client is considering the strategy, suggest that they hold off conversion until the following year. We have contacted the IRS and will report information when we receive it. For now, it would seem that the best defense is to wait a while between the time of the contribution and the time of the conversion.



¹ TIPRA '05 (P.L. 109-222) §512

² Ebeling, Ashlea (January 20, 2012) "The Serial Backdoor Roth, A Tax-Free Retirement Kitty" Forbes. Available at: www.forbes.com/sites/ashleaebeling/2012/01/20/the-serial-backdoor-roth-a-tax-free-retirement-kitty/

Interplay of passive activity, community property, and death

TAX: There is scant authority on a situation that must arise often.

By Richard B. Malamud, CPA, J.D., LL.M.

Guest Contributor

Sometimes there just aren't any answers to questions that have been around for more than 20 years. Take this situation, for example: A spouse in a community property state dies in a year in which their basis in a community property apartment building is \$1,500,000, it has a fair market value of \$1,800,000, and they have \$500,000 of passive loss carryovers from the building. What happens to the suspended losses?

The answer reminds me of the famous joke about the person interviewing for an accounting position: "Question — What happens when you have a §469 (passive activity), a death, and a §1014 basis adjustment for community property? Answer — What do you want the answer to be?"

This has to happen all the time, but there are no official statements from the IRS on how to handle it.

What we know

Two code sections apply to this situation: IRC §469(g)(2), relating to passive activity loss carryovers at death, and IRC §1014(b)(6), relating to step-up in basis at death.

Under IRC §469(g)(2), the unused passive loss carryovers can be used in the year of death *"to the extent such losses are greater than the excess (if any) of —*

(i) the basis of the property in the hands of the transferee (FMV), over

(ii) the adjusted basis of such property immediately before the death of the taxpayer ..."

EXAMPLE 7-10: Assume the decedent was the sole owner of the apartment building listed above. In that case, the \$500,000 carryover must be reduced by \$300,000 (\$1,800,000 - \$1,500,000). Thus, the amount that can be used in the year of death is \$200,000 and the basis in the apartment for the heirs is \$1,800,000, its fair market value. The remaining \$300,000 suspended loss is lost.

Community property

If the apartment was held as community property, when looking at the decedent only, one-half of the above allowed passive loss is allowed (\$100,000). The question is, what happens to the surviving spouse's passive loss carryover of \$250,000? Is that share also entitled to a \$100,000 loss in the year of the spouse's death? What happens to the \$250,000 passive loss carryover (the survivor's half)?

The answer to the question about the \$100,000 loss in the year of death depends on whether IRC §469(g) applies to both halves of the community property or just the decedent's half. IRC §469(g) says it applies "if an interest in the activity is transferred by reason of the death of the taxpayer."

The problem is, the basis of the surviving spouse's interest is adjusted because of the death of the taxpayer's spouse, not the taxpayer. That adjustment is based on IRC §1014(b)(6), not IRC §469, and IRC §1014 says its provisions apply only to that section. It makes no reference to any other section of the Internal Revenue Code.

In the only article that was found that addresses the subject, Professor Leo Schmolka states that "both shares of the community interest are treated upon the death of either spouse as transferred by reason of the death of the taxpayer within the meaning of 469(g)(2)." But, as the article states, that would be the rule if the author were king.¹

If Schmolka's theory is true, then both halves of the property would be treated as if they were the result of the death of the taxpayer and the passive loss would be allowed to the extent of the IRC §469(g)(2) limit (\$200,000, in this case). If the property were worth more than \$2,000,000 at death, none of the loss would be allowed in the year of death and there would be no carry over. If the property was worth \$1,500,000 or less, the \$500,000 would be allowed in the year of death and the basis would be reduced to the fair market value.

What if you or the IRS disagrees with Schmolka, by making the argument that the survivor's half of the community property is not treated as disposed of on the death of the taxpayer's spouse for purposes of IRC §469? In that case, could

the survivor not use his or her half of the passive loss carryover in the year of the spouse's death? IRC §1014 would still apply at death and the survivor's half of the property would receive a fair market value step-up to \$900,000.

EXAMPLE 7-11: Assume the facts above, and that the property is community property and IRC §269(g) does not apply to the survivor's half of the property. As to the decedent's share, the final tax return would include the \$100,000 passive loss, but none would be permitted for the survivor's share.

The question then becomes, does the survivor still have their \$250,000 passive loss carryover? It would seem so, but there is no support for or against it. The basis of the property would be the total fair market value (\$1,800,000).

It would seem the logical result is the first one, where both spouse's interests are treated under both sections as acquired due to the death of the taxpayer. However, the statute is not clear and there is no guidance. In some situations, the added loss carryover may be better than the current deduction. It would be nice if the IRS or Congress could fix this by statute or regulation.

If both are allowed the passive loss in year of death:			
Loss in year of death	\$200,00		
Loss carryover	none		
Basis	\$1,800,000		

Only decedent allowed loss in year of death:			
	Decedent	Survivor	Total
Loss in year of death	\$100,000	-	\$100,000
Loss Carryover — Alternative 1	-	\$250,000	\$250,000
Loss Carryover — Alternative 2	none		
Basis	\$900,000	\$900,000	\$1,800,000



¹ Schmolka, Leo. "Passive Activity Losses of Trusts and Estates: The Regulations (If I Were King)." Tax Notes, Vol. 111, No. 12 (June 19, 2006)

About the author

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