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Rollovers and Conversions to Roth IRAs and Designated Roth Accounts: Proposed Changes in Budget Reconciliation

Introduction

Individuals can save for retirement through tax-advantaged vehicles such as Individual Retirement Accounts (IRAs) and qualified retirement plans (for instance, employer-sponsored 401(k)s or defined benefit plans). Individuals may be able to roll over savings in one type of qualified plan, account, or IRA to another type subject to a number of requirements. Section 138311 of H.R. 5376, as reported by the House Committee on the Budget on November 3, 2021, would modify certain rollover rules.

IRA Contributions and Withdrawals

IRAs are tax-advantaged investment accounts for retirement savings. Congress has authorized two types of IRAs: traditional and Roth. Eligible individuals may contribute to their IRA(s) up to the IRA contribution limit ($6,000 [$7,000 for individuals age 50 and older] in 2021).

Traditional IRAs. Anyone with wage income can contribute to a traditional IRA. Contributions to traditional IRAs may be deductible from taxable income (i.e., they reduce taxable income). Deductibility of traditional IRA contributions is phased out based on adjusted gross income (AGI), tax filing status, and household workplace pension coverage. Individuals who cannot deduct part or all of their traditional IRA contributions can make nondeductible contributions.

- *Deductible IRA contributions* reduce taxable income. Withdrawals of deductible contributions (and any investment earnings) are included in taxable income.

- *Nondeductible IRA contributions* are not deductible from taxable income. The portion of a withdrawal attributable to the nondeductible contributions is not included in taxable income. However, any *investment earnings* that have accrued *are* included in taxable income.

Roth IRAs. Individuals with AGI under specified limits can contribute to a Roth IRA (e.g., a single filer with an AGI of less than $140,000 in 2021).

- *Roth IRA contributions* are not deductible (i.e., they are made from after-tax income). Qualified withdrawals (which include contributions *and* any investment earnings) from Roth IRAs are not included in taxable income. Qualified withdrawals are those made (1) after age 59½, death, or disability and (2) from accounts that have been held for at least five years.

Qualified Plan Contributions and Withdrawals

A qualified plan is an employer-sponsored retirement plan that receives special tax treatment, such as a 401(k) plan, a 403(b) plan, a 457(b) plan, or a defined benefit (DB) plan. Employees and/or employers make contributions to a qualified plan. Plans may permit various types of contributions.

- *Pre-tax contributions* lower an individual's taxable income. Withdrawals of savings (i.e., contributions and any investment earnings) attributable to pre-tax contributions are included in taxable income.

- *Designated Roth account contributions* do not lower taxable income. Qualified withdrawals from designated Roth accounts are not included in taxable income.

- A*fter-tax (non-Roth) contributions* do not lower taxable income. Withdrawals attributable to after-tax (non-Roth) contributions are not included in taxable income, whereas investment earnings attributable to those contributions *are* included in taxable income.

An individual's pre-tax and designated Roth account contributions (called *elective deferrals*) cannot exceed specified limits ($19,500 [$26,000 for individuals age 50 and older] in 2021). After-tax (non-Roth) contributions are not subject to the elective deferral limit. However, *total contributions* (which include elective deferrals, employer contributions, and any after-tax [non-Roth] contributions) cannot exceed specified limits ($58,000 [$64,500 for individuals age 50 and older] in 2021). After-tax (non-Roth) contributions are typically made after an individual has already contributed the maximum amount of elective deferrals.

Rollovers and Conversions to Roth IRAs and Designated Roth Accounts

Individuals can preserve the tax benefits of their retirement savings through a *rollover*. A rollover is a transfer of a portion or all of the savings from one qualified retirement plan, account, or IRA to another plan, account, or IRA. In general, a *conversion* is a type of rollover that occurs when savings are rolled over from a traditional IRA, qualified plan, or account (which includes any after-tax [non-Roth] savings) to a Roth IRA or designated Roth account.

Prior to 2010, conversions to Roth IRAs were limited to taxpayers with AGI of less than $100,000 (to prevent high-income taxpayers from indirectly funding Roth IRAs). The Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA; P.L. 109-222) eliminated the AGI limit for Roth conversions beginning in 2010. As a result, individuals have been able to circumvent Roth contribution limits by converting (1) traditional IRA funds to a Roth IRA or (2) after-tax (non-Roth) funds in a qualified plan to a Roth IRA or designated Roth account. This is sometimes informally referred to as a *backdoor Roth IRA* or *mega backdoor Roth*, respectively.

Backdoor Roth IRA. A backdoor Roth IRA refers to the conversion of traditional IRA funds—typically after making nondeductible IRA contributions—to a Roth IRA.

Mega Backdoor Roth. Because contribution limits in qualified plans are higher than those for IRAs, individuals who convert qualified plan savings to Roth IRAs can fund IRAs in amounts that exceed IRA contribution limits. Similarly, individuals who convert savings in after-tax (non-Roth) accounts to designated Roth accounts (in an *in-plan conversion*) can fund Roth accounts in amounts that exceed elective deferral limits.

An individual's ability to convert savings attributable to after-tax (non-Roth) contributions from a qualified plan to a Roth IRA depends on how the qualified plan is structured. The plan must permit (1) after-tax contributions and (2) *in-service distributions* for non-hardship reasons. In-service distributions are withdrawals taken while an employee is still working (generally after reaching a specified age). A Plan Sponsor Council of America Survey of 401(k) and Profit-Sharing Plans found that 20.9% of plans permitted after-tax contributions and 56.3% permitted in-service (non-hardship) distributions in 2019.

Converting savings attributable to after-tax (non-Roth) contributions to a Roth IRA or designated Roth account shields future investment earnings from taxation. To minimize taxation on earnings, some financial professionals have recommended converting savings soon after making after-tax (non-Roth) contributions.

Proposed Changes in Reconciliation

Section 138311 of H.R. 5376 would prohibit (1) all taxpayers from converting after-tax (non-Roth) savings in qualified plans and nondeductible IRA funds to Roth IRAs and designated Roth accounts after December 31, 2021, and (2) high-income taxpayers from converting pre-tax savings in qualified plans or IRA savings attributable to deductible contributions to Roth IRAs or designated Roth accounts after December 31, 2031. High-income taxpayers would be defined as

- single taxpayers (or those married filing separately) with modified adjusted gross income (MAGI, as defined in the bill) over $400,000;
- married taxpayers filing jointly with MAGI over $450,000; and
- heads of households with MAGI over $425,000.

These income thresholds would be adjusted for inflation. **Table 1** provides an overview of how the proposed changes would affect rollovers. The Joint Committee on Taxation estimated that Section 138311 would increase Treasury revenue by $749 million from FY2022 through FY2031.

In summary, Section 138311 would prohibit (1) all taxpayers from funding Roth IRAs or designated Roth accounts through backdoor or mega backdoor methods starting in 2022, and (2) high-income taxpayers from converting pre-tax savings in qualified plans or IRA savings attributable to deductible contributions to Roth IRAs or designated Roth accounts starting in 2032.

Table 1. Table 1. Rollovers to Roth IRAs and Designated Roth Accounts

Current tax treatment and proposed changes in H.R. 5376

Rollover Type	Current Tax Treatment of Rollover
Would be prohibited for all taxpayers after 2021	
Traditional IRA (nondeductible) to Roth IRA (sometimes called a *backdoor Roth IRA*)	Earnings included in taxable income
After-tax (non-Roth) savings in qualified plan to Roth IRA (sometimes called a *mega backdoor Roth IRA*)	
After-tax (non-Roth) savings in qualified plan to designated Roth account in qualified plan (sometimes called a mega backdoor Roth)	
Would be prohibited for high-income taxpayers after 2031	
Traditional IRA (deductible) to Roth IRA	Rollover amount included in taxable income
Pre-tax savings in qualified plan to Roth IRA	
Pre-tax savings in qualified plan to designated Roth account in qualified plan	
Would be unchanged	
Roth IRA to Roth IRA	Not taxable
Designated Roth account in qualified plan to Roth IRA	

Source: Congressional Research Service (CRS).

Notes: High-income taxpayers include single taxpayers (or those married filing separately) with taxable income over $400,000; married taxpayers filing jointly with taxable income over $450,000; and heads of households with taxable income over $425,000.

For Further Information

Joint Committee on Taxation, JCX-42-21, at https://www.jct.gov/publications/2021/jcx-42-21/

CRS Report RL34397, Traditional and Roth Individual Retirement Accounts (IRAs): A Primer

House Committee on Rules, H.R. 5376 – Build Back Better Act, at https://rules.house.gov/bill/117/hr-5376

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