Reporting Nondeductible IRAs on Form 8606

What Gets Reported on Form 8606?

Form 8606 is used to report a variety of transactions related to traditional individual retirement agreements (IRAs), Roth IRAs, and other types of retirement plans like SEP-IRAs and SIMPLE IRAs.

The main reasons for filing Form 8606 would entail the following:

- Contributing to a nondeductible traditional IRA
- Converting a “pre-tax” traditional, SEP, or SIMPLE IRA to a Roth IRA
- Early distributions from Roth IRAs

What is a Nondeductible IRA?

Informally known as a “backdoor IRA”, a nondeductible IRA is a traditional IRA that does not provide an immediate pre-tax benefit, as the name implies.

Taxpayers who have nondeductible IRAs opt to contribute to them despite the lack of tax benefits if they are concerned about having sufficient retirement savings in the future. If you and/or your spouse do not have access to an employer-sponsored retirement plan at work, there are fewer restrictions on opening IRAs. However, in addition to restrictions based on income and filing status, the deductibility threshold of your traditional IRA contributions is lower if you are eligible to participate in an employer plan.

These contributions should be reported on Form 8606 to prevent double taxation of your IRA distributions in the future. Normally, a traditional IRA entails deferring the taxation of your contributions to retirement age. You would receive a deduction in the year of contribution, then owe taxes on the distributions in the future. A nondeductible IRA creates a nontaxable portion in the future which is based on your post-tax contributions that did not result in an immediate benefit. The taxable portion is based on the growth between the contribution and the time of distribution.

How Does IRA Conversion Impact My Taxes?

Converting a pre-tax IRA like a traditional, SEP, or SIMPLE IRA to a Roth IRA can be beneficial, but also carry a host of tax consequences. Common reasons for choosing to convert these assets include execting higher income in retirement than the present moment, expecting to retire in a state with high income taxes and/or no preferential treatment for retirement income, and having other items that will help offset the conversion, like capital or business losses.

Regardless of the outcome, you will need to file Form 8606 if a conversion is executed.

The amount of the IRA assets that get converted will be treated as ordinary income, and not any of the preferential treatment given to retirement distributions after age 59 1/2 or capital gain income. The taxable amount is determined by whether your contributions to the IRA were actually deductible, such as if you fell within the limits when the contributions were made and were not eligible to participate in an employer-sponsored retirement plan.

Paying the taxes on this transaction must be considered carefully, as you may face consequences for using some of the converted funds to cover the tax. If you are under age 59 1/2 at the time of conversion, you may incur the 10% early withdrawal penalty on any amounts that are not directly converted to Roth assets.

Are Early Roth IRA Distributions Taxable?

If you are under age 59 1/2 at the time of receiving a Roth IRA distribution, you may owe taxes and early withdrawal penalties on the amount withdrawn. **Currently, the early withdrawal provision has been suspended until December 31, 2020 for IRA owners pursuant to the CARES Act.**

The form is used to report the amount distributed, how long the assets have been held in the account, and if your distribution meets an exception (such as being a first-time homebuyer). If the assets have remained in the Roth IRA for five years or longer after the contributions, you may owe fewer or no early withdrawal penalties.

Form 8606 does not need to be completed if you are over age 59 ½ at the time you received Roth IRA distributions.