



BACKDOOR ROTH IRA AND THE PRO RATA RULE: WHY YOU OWE MORE TAX

Understanding the IRA aggregation rule – and how to execute a backdoor Roth conversion without triggering an unexpected tax liability.

Palmer Wealth Group™

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The call came in April. A client had done everything right the previous January: made a non-deductible contribution to a traditional IRA, then executed what should have been a clean backdoor Roth conversion within weeks. The financial plan called for it. The mechanics were confirmed. Then their CPA called with an unexpected tax liability.

The culprit was a rule most high-income investors have never encountered: the pro rata rule. Understanding it is the difference between a clean conversion and a costly surprise – and knowing how to address it is the difference between a strategy that works and one that only appears to.

The scenario above is a composite hypothetical illustration, not a description of any specific client's situation.

WHY HIGH EARNERS ARE LOCKED OUT OF THE ROTH IRA — AND HOW THE BACKDOOR OPENS IT

The Roth IRA provides two significant tax advantages: tax-free growth on investments held within the account (subject to investment risk and market conditions) and tax-free qualified withdrawals in retirement, with no required minimum distributions (the annual withdrawals the IRS mandates from tax-deferred accounts beginning at age 73). But Congress placed income limits on direct contributions. For the 2026 tax year, per IRS Notice 2025-67, single filers are fully phased out above \$168,000 in modified adjusted gross income (MAGI); married couples filing jointly above \$252,000. Many households we serve at Palmer Wealth Group earn above these thresholds.

The backdoor Roth IRA is the legal workaround. There are no income limits on non-deductible IRA contributions, and none on Roth conversions (the transfer of IRA assets into a Roth IRA). A high-income earner makes non-deductible contributions to a traditional IRA, then executes a backdoor Roth conversion. The Tax Cuts and Jobs Act of 2017 (TCJA) gave this approach legislative legitimacy: the Joint

Explanatory Statement of the Conference Committee acknowledged the strategy four separate times, in footnotes 268, 269, 276, and 277. For clients navigating related 2026 Roth changes, [2026 Roth Catch-Up Rules for High Earners](#) covers the mandatory Roth catch-up rules affecting the same income group.

THE 2026 CONTRIBUTION LIMITS AND INCOME PHASE-OUTS

For the 2026 tax year, the IRA contribution limit is \$7,500 (under age 50) or \$8,600 (50 and older), reflecting inflation indexing under the SECURE 2.0 Act (the Setting Every Community Up for Retirement Enhancement Act of 2022). The Roth IRA MAGI phase-out for single filers runs from \$153,000 to \$168,000; for married filing jointly, from \$242,000 to \$252,000. All figures per IRS IR-2025-111 and Notice 2025-67, adjusted annually.

THE TWO-STEP WORKAROUND: NON-DEDUCTIBLE CONTRIBUTIONS, THEN CONVERSION

The backdoor Roth involves two steps. First, the taxpayer makes a non-deductible contribution to a traditional IRA – no deduction is taken, and the funds carry an after-tax cost basis. Second, the taxpayer converts that IRA to a Roth IRA. One point demands attention: conversions are irrevocable under current law. The TCJA eliminated Roth conversion recharacterizations (the ability to undo a completed conversion) for tax years after December 31, 2017. And the assumption that the entire backdoor Roth conversion will be tax-free is precisely where the pro rata rule intervenes.

THE PRO RATA RULE EXPLAINED — WHAT THE IRS ACTUALLY DOES WITH YOUR IRA BALANCES

The pro rata rule is the IRS mechanism that determines what portion of any IRA conversion is taxable. It does not evaluate individual accounts or care which custodian holds which dollars. It treats every non-Roth IRA you own as a single pool. Under Internal Revenue Code Section 408(d)(2) – the aggregation rule for IRA distributions – all traditional IRAs, SEP IRAs (Simplified Employee Pension IRAs), and SIMPLE IRAs (Savings Incentive Match Plans for Employees) are treated as one contract. Your after-tax basis recovers proportionally across that pool. You cannot isolate your non-deductible contributions for a tax-free conversion.

The Investment Company Institute's 2024 IRA Owners Survey found that 59% of traditional IRA-owning households hold rollover assets, and 85% of those rolled over their entire employer plan balance at the most recent rollover. Most clients attempting a backdoor Roth conversion carry a pool of pre-tax rollover dollars they have not factored into the tax liability calculation.

THE IRA AGGREGATION RULE — EVERY ACCOUNT IS ONE POOL

The aggregation rule under IRC §408(d)(2) applies across every non-Roth IRA you own regardless of custodian or account number. A traditional IRA at one brokerage, a rollover IRA at another, and a SEP IRA from prior self-employment are all one account for conversion purposes. What does not aggregate: 401(k), 403(b) (tax-sheltered annuity plans), 457(b) (deferred compensation plans), inherited IRAs, and

Roth IRAs. Sarah Brenner, JD, of Ed Slott and Company, a practitioner-focused IRA education organization, has documented that executives with former-employer rollover IRAs or SEP IRAs routinely overlook these balances when planning a backdoor Roth conversion — the most common source of the unexpected tax liability we described at the outset.

THE DECEMBER 31 RULE — WHY TIMING DOESN'T SAVE YOU

The operative figure is not the IRA balance on the contribution date or the conversion date. It is the aggregate December 31 balance of all non-Roth IRAs in the year of conversion. IRS Form 8606 requires you to enter on Line 6 the total value of all traditional, SEP, and SIMPLE IRAs as of December 31 of the conversion year. A January contribution followed by a February conversion does not escape the pro rata rule if a pre-tax IRA balance exists on December 31 of that same year. Michael Kitces, CFP, has documented that this timing confusion runs in both directions: clients who convert immediately and those who wait both assume, incorrectly, that the conversion date alone controls their tax liability.

CALCULATING YOUR TAXABLE CONVERSION AMOUNT: A WORKED EXAMPLE

The following is a hypothetical illustration for educational purposes only. Actual tax outcomes depend on individual circumstances. No investment return is implied or guaranteed. Consult a qualified tax professional before implementing any conversion strategy.

Suppose you hold \$93,000 in a pre-tax rollover IRA and make a \$7,000 non-deductible contribution to a new traditional IRA, then immediately execute a backdoor Roth conversion of that \$7,000. Your total non-Roth IRA pool on December 31 is \$100,000. After-tax basis is 7% of the pool ($\$7,000 \div \$100,000$). Only 7% of the converted amount is tax-free; the remaining 93%, or \$6,510, creates a tax liability. This calculation is governed by IRC §72 and the aggregation rule under IRC §408(d)(2). Andy Ives of Ed Slott and Company clarifies: the pro rata rule does not create double taxation — it defers the tax savings proportionally rather than eliminating them.

FORM 8606 — THE PAPER TRAIL THE PRO RATA RULE REQUIRES

Every year you make a non-deductible contribution to a traditional IRA, execute a backdoor Roth conversion, or take a distribution from an IRA with existing after-tax basis, you must file IRS Form 8606 with your tax return. This form is how the IRS tracks your cumulative IRA cost basis across years and custodians. Under IRC §6693(b)(2), failure to file results in a \$50 penalty per form; overstating basis carries a \$100 penalty. The more significant consequence is the loss of your documented after-tax basis — without it, you risk a tax liability on dollars already taxed when you eventually take distributions.

WHEN FORM 8606 IS REQUIRED AND WHAT HAPPENS IF YOU MISS IT

The form is required in three situations: you make a non-deductible contribution to a traditional IRA; you execute a backdoor Roth conversion; or you take a distribution from a traditional IRA with after-tax basis. Missed filings can generally be filed late, but retroactive filings require careful basis reconstruction. Consult a CPA or tax attorney before filing late Form 8606s to avoid inconsistencies with prior returns.

TRACKING BASIS ACROSS MULTIPLE YEARS: THE CUMULATIVE RECORD REQUIREMENT

Your IRA basis is not tracked by your custodian. It is tracked by you, on Form 8606, filed each year you make non-deductible contributions or execute a backdoor Roth conversion. Kitces has described this as a “cream in the coffee” problem: once after-tax dollars mix with pre-tax dollars, every subsequent distribution or conversion draws a proportional share of both layers, indefinitely. The Congressional Research Service report R48456 found that rollovers accounted for 96.4% of all traditional IRA inflows in the most recently available IRS Statistics of Income data. That pre-tax rollover pool is what every backdoor Roth conversion is calculated against. Retain Form 8606 copies and your full IRA basis history as permanent records — this obligation extends well beyond the standard three-year statute of limitations.

THREE STRATEGIES TO NEUTRALIZE THE PRO RATA TRAP

Understanding the pro rata rule is the diagnosis. What follows is the treatment. For most clients, at least one strategy below can reduce or eliminate the tax liability of a backdoor Roth conversion. None is universally applicable — the right approach depends on your IRA balances, employer plan, income, and timeline.

This article is for educational purposes only and does not constitute tax or legal advice. Consult a qualified CPA or tax attorney before executing any strategy described below.

STRATEGY 1 — ROLL PRE-TAX IRA BALANCES INTO YOUR 401(K) BEFORE CONVERTING

The most direct solution is to move pre-tax IRA dollars out of the aggregated pool before executing the backdoor Roth conversion. IRC §408(d)(3)(A)(ii) permits rollover of pre-tax IRA funds into a qualifying employer plan — a 401(k), 403(b), or governmental 457(b). Employer plans accept only the pre-tax portion, leaving an IRA of pure non-deductible contributions that can be converted to a Roth with no pro rata contamination. The Journal of Accountancy published the foundational analysis of this mechanism. For clients evaluating whether their plan design supports this, [401\(k\) Plan Costs, Design Options, and Tax Benefits](#) covers the plan design decisions that determine whether a 401(k) accepts incoming IRA rollovers. Important limitation: not all plans permit incoming IRA rollovers. Verify your plan documents, and complete the rollover before December 31 of the conversion year.

STRATEGY 2 — TIME YOUR CONTRIBUTION AND CONVERSION TO MINIMIZE TAXABLE EARNINGS

Convert as quickly as possible after the non-deductible contribution to limit taxable earnings that can accumulate in the traditional IRA. Vanguard’s and Fidelity’s current guidance both recommend a tight window for this reason. Clients who experience a temporary income dip — a business transition year, a sabbatical, or a gap between roles — may find that executing the backdoor Roth conversion while in lower tax brackets reduces the overall tax liability on any earnings that have accumulated. Regarding the step transaction doctrine — a rule that can re-characterize two related transactions as a single preplanned one — the TCJA conference report’s four explicit acknowledgments substantially addressed this concern. Ed Slott’s firm views a same-month gap as adequate; Kitces recommends a 12-month wait as the

conservative position. We recommend discussing the timing question with your financial advisor and tax professional.

STRATEGY 3 — WHEN YOU CANNOT ZERO THE PRE-TAX BALANCE: WHAT ELSE TO CONSIDER

Some clients face a pro rata problem they cannot resolve through an employer plan rollover — retirees without an active plan, self-employed individuals whose solo 401(k) does not accept rollovers, or W-2 employees whose plan restricts them. As a general illustration only, at a top federal marginal rate of 37% applied to the full conversion amount, a client holding \$500,000 in a pre-tax rollover IRA who cannot roll those funds to an employer plan could face an approximate federal tax liability of \$150,000 or more before state taxes. Actual tax outcomes depend entirely on individual circumstances and applicable rates. In such cases, a financial advisor can help evaluate alternative strategies. SECURE 2.0 Section 601 now permits SEP and SIMPLE IRAs to accept Roth contributions directly, providing a new path for self-employed clients that bypasses the pro rata issue entirely.

[Beyond the 401\(k\): How Physicians Can Maximize Retirement Savings in 2026](#) provides a broader look at retirement savings vehicles for high-income professionals facing the same SEP IRA complications.

WHEN THE BACKDOOR ROTH MAY NOT BE THE RIGHT STRATEGY

The backdoor Roth conversion is a legitimate, legislatively acknowledged strategy — but its continued availability is not guaranteed, and its current status should be verified before acting on any strategy in this article. Congressional proposals have targeted the backdoor Roth on multiple occasions, most recently in 2021 and in subsequent executive budget proposals. None has been enacted as of this article's preparation date of April 2026. The structural political vulnerability remains real and should be part of any long-range planning conversation. Tax law changes frequently; readers should confirm current regulatory status with a qualified tax professional before implementing any strategy discussed here.

[The Entrepreneur's Blind Spot: When Business Success Overshadows Personal Wealth Planning](#) addresses wealth planning gaps common for entrepreneurs with legacy SEP IRA balances — the most frequent profile of clients for whom the pro rata trap becomes permanent. For clients executing a full Roth conversion to zero their pre-tax balance, [Charitable Giving Tax Optimization](#) covers donor-advised fund strategies that can partially offset the resulting tax liability in the same year.

THE CLIENTS FOR WHOM THE PRO RATA MATH DOESN'T WORK

Clients with large pre-tax IRA balances they cannot roll to an employer plan face a calculation that makes the backdoor Roth conversion unattractive in most years. Clients in the top 37% tax bracket who expect to retire into meaningfully lower tax brackets may find that traditional IRA deferral outweighs the Roth tax-free growth benefit on a net present value basis. The arithmetic is highly individualized. A financial advisor can model the trade-off using your actual IRA balances, income projections, and retirement timeline — the only reliable way to evaluate whether a backdoor Roth conversion makes sense for your situation.

LEGISLATIVE RISK — WHAT CONGRESS HAS ALREADY ATTEMPTED

No legislation eliminating or restricting backdoor Roth conversions has been enacted by Congress as of this article's preparation date. The strategy has survived two presidential budget cycles and one reconciliation bill that explicitly targeted it. That is a statement about the past, not a prediction about the future. We do not predict whether, or when, future legislation may change this. We do recommend treating legislative risk as a real planning consideration when building a multi-year Roth conversion strategy, and confirming current law with a qualified tax professional before acting.

FREQUENTLY ASKED QUESTIONS

Q: Does a backdoor Roth IRA conversion avoid all taxes?

Not necessarily. If you hold pre-tax balances in traditional IRAs, SEP IRAs, or SIMPLE IRAs on December 31 of the conversion year, the IRS aggregates all those accounts under IRC §408(d)(2) and applies the pro rata rule. Only the proportion of your total non-Roth IRA pool representing non-deductible contributions is eligible for tax-free conversion. A client holding \$93,000 in a pre-tax rollover IRA who adds \$7,000 in non-deductible contributions would find 93% of the backdoor Roth conversion creates a tax liability. Tax-free conversion is achievable only when the pre-tax IRA pool is at or near zero. Consult a financial advisor or qualified tax professional for guidance specific to your situation.

Q: Does my rollover IRA count against the pro rata rule for backdoor Roth?

Yes. Under IRC §408(d)(2), every traditional IRA, SEP IRA, and SIMPLE IRA you own — including rollover IRAs funded from former employer 401(k) plans — is treated as a single pool for conversion purposes, regardless of which custodian holds the account. The only excluded accounts are employer-sponsored plans (401(k), 403(b), 457(b)), inherited IRAs, and Roth IRAs. If your rollover IRA contains pre-tax dollars, those dollars increase the taxable portion of any backdoor Roth conversion you execute that year. Many high-income earners are unaware of this until they file their taxes.

Q: Can I open a separate IRA just for my nondeductible contribution to avoid the pro rata rule?

No. The aggregation rule under IRC §408(d)(2) applies across all non-Roth IRAs you own, regardless of how many accounts or custodians are involved. Placing non-deductible contributions in a new, separate IRA at a different brokerage does not isolate those after-tax dollars from the pro rata calculation. Per IRS Form 8606 Line 6, the IRS uses the combined December 31 balance across all your non-Roth IRAs — not the balance of any individual account — to determine what portion of a backdoor Roth conversion is taxable.

Q: When should I convert my nondeductible IRA contribution to avoid taxes?

There is no single optimal conversion date, but timing your backdoor Roth conversion thoughtfully can minimize the resulting tax liability. Converting quickly after making non-deductible contributions limits taxable earnings that accumulate in the traditional IRA before conversion. Executing the conversion during a year when you fall into lower tax brackets — a business transition, gap year, or early retirement — can reduce the liability further. The primary tool for eliminating the pro rata problem, however, remains rolling pre-tax IRA balances into a qualifying employer plan before converting, per IRC §408(d)(3)(A)(ii). Consult your financial advisor or a tax professional to evaluate which approach applies to your situation.

Q: What happens if I forget to file Form 8606 for my IRA?

Forgetting to file Form 8606 triggers a \$50 IRS penalty per missed form, per IRC §6693(b)(2), unless you can demonstrate reasonable cause. The more significant consequence is the loss of your documented after-tax IRA basis. Without that record, you risk paying tax a second time on dollars already taxed when you eventually take distributions from the account. Missed filings can generally be filed late, but the reconstruction must be consistent with all prior returns. Work with a financial advisor, CPA, or tax attorney before attempting to file retroactively.

About Palmer Wealth Group™

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Investments held within an IRA or Roth IRA are subject to market risk, including the possible loss of principal. Tax-free growth within a Roth IRA depends on investment performance and is not guaranteed.

Hypothetical examples in this article are for illustrative purposes only. No specific investment return, account balance, or tax outcome is guaranteed. Actual results will vary based on individual circumstances, applicable tax law, and market conditions.

Regulatory thresholds, contribution limits, and tax rates cited in this article are current as of the preparation date of April 16, 2026, per IRS IR-2025-111 and Notice 2025-67. Tax law changes frequently; confirm current limits and rules with a qualified tax professional before acting.

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