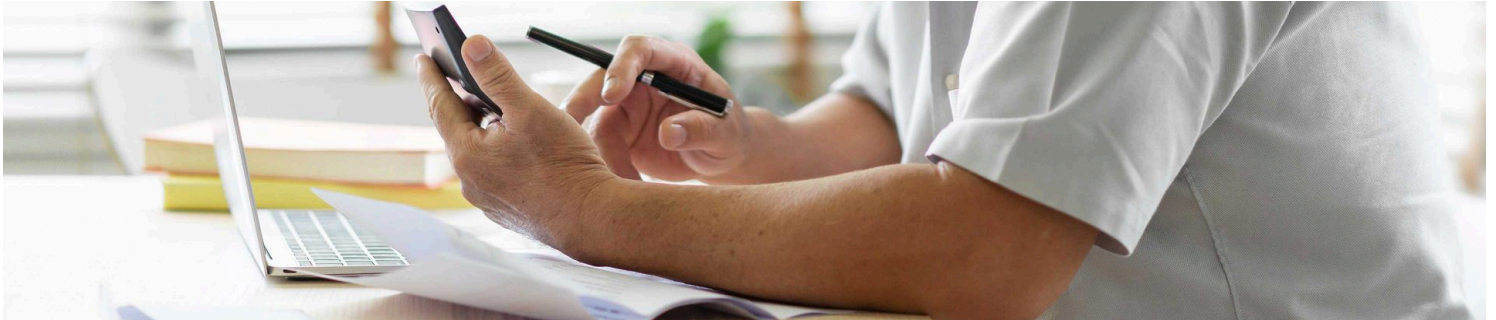




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COMPLIANCE, TAX & ACCOUNTING

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Individual retirement accounts: When is IRS Form 8606 required?

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Overview

After certain individual retirement account (IRA) related transactions are completed, it might be necessary for an IRA owner (or beneficiary) to include Internal Revenue Service (IRS) Form 8606,

year that he/she:

- Makes a nondeductible contribution(s) to a traditional IRA, including a repayment of a qualified disaster, a qualified reservist, or a qualified birth or adoption distribution.
- Receives a distribution(s) from a traditional, traditional SEP, or traditional SIMPLE IRA and the basis in his/her IRAs is more than zero. For this purpose, a distribution doesn't include a distribution that is rolled over (other than a repayment of a qualified disaster), qualified charitable distribution, one-time distribution to fund an HSA, conversion, recharacterization, or return of certain contributions.
- Transfers (or receives via transfer) all or part of a traditional, traditional SEP, or traditional SIMPLE IRA to his/her spouse under a divorce or separation agreement where the transfer resulted in a change in the basis of the IRA of either spouse.
- Converts any amount(s) from a traditional, traditional SEP, or traditional SIMPLE IRA to a Roth, Roth SEP, or Roth SIMPLE IRA.
- Receives a distribution(s) from a Roth, Roth SEP, or Roth SIMPLE IRA (other than a rollover, recharacterization, or return of certain contributions).
- Receives a distribution(s) from an inherited traditional, traditional SEP, or traditional SIMPLE IRA that has a basis, or receives a distribution from an inherited Roth, Roth SEP, or Roth SIMPLE IRA that wasn't a qualified distribution.

Traditional IRA nondeductible contributions

If an IRA owner does not claim a deduction for a regular contribution, the amount contributed is after-tax and is considered basis. Therefore, the IRA owner must file IRS Form 8606 for the year of the contribution to inform the IRS that the contribution is nondeductible. Part I of Form 8606 keeps track of this IRA basis.

Other methods by which basis is accumulated in an IRA is by rollover of after-tax assets from a qualified employer plan and/or repayment of a qualified reservist or disaster distribution(s). An individual is not required to file Form 8606 for the year an employer plan-to-IRA rollover deposit is made if a portion of the rollover is after-tax. However, the IRA owner must keep appropriate records for future Form 8606 filing.

traditional, traditional SEP, and traditional SIMPLE IRA distributions

When an IRA owner (or beneficiary) has any traditional, traditional SEP, or traditional SIMPLE IRA which contain after-tax assets and he/she takes a distribution from any of his/her IRAs (or inherited IRAs) or completes a conversion, Form 8606 must be filed for such year. The form is used to determine the prorated after-tax and pretax amounts distributed. The after-tax amount is distributed tax-free and penalty-free. The portion of the distribution that is attributable to the pretax amount is the taxable portion of the IRA distribution. Such distributions are reported in Part I of Form 8606. For completing Part 1 of the form, distributions do not include amounts rolled over (except for qualified disaster distribution repayments), qualified charitable distributions, one-time distribution to fund an HSA, conversions, recharacterization, or return of certain contributions. However, an individual must complete Part 1 of Form 8606 if he/she converted a portion of any traditional, traditional SEP, or traditional SIMPLE IRA to a Roth, Roth SEP, or Roth SIMPLE IRA but only if a nondeductible contribution was made to a traditional IRA in the same year of conversion or a previous year.

Failure to file Form 8606 for a distribution could result in the IRA owner (or beneficiary) paying income tax and the additional 10 percent early distribution penalty tax on amounts that should be tax-free.

Example: Katlyn made a nondeductible contribution to her traditional IRA for tax year 2017. When filing her 2017 tax return, she included IRS Form 8606 to report her \$5,000 nondeductible contribution. That is the only nondeductible contribution she has ever made to any of her traditional IRAs and the only after-tax amount in her traditional IRAs. The total balance, or fair market value (FMV), in all of Katlyn's traditional, traditional SEP, and traditional SIMPLE IRAs at the end of 2023 was \$20,000.

In 2023, Katlyn took \$5,000 from one of her traditional IRAs. When filing her 2023 federal income tax return, she included Form 8606 and intended to claim the entire \$5,000 as non-taxable. However, the taxation of the \$5,000 is based on the proportions of her total pretax and after-tax amounts versus the year-end balance. For Form 8606 calculation purposes, the adjusted 2023 year-end balance is \$25,000 (i.e., the \$20,000 FMV on December 31, 2023, plus the \$5,000 distribution). Therefore, based on the December 31, 2023, FMV, 80 percent of her Katlyn's assets are

a taxable amount of \$4,000 (80 percent of the distribution amount) and a tax-free amount of \$1,000 (20 percent of the distribution amount), the amount attributable to the basis.

Traditional ‘type’ IRA to Roth ‘type’ IRA conversions

A distribution from a traditional, traditional SEP, or traditional SIMPLE IRA that is subsequently converted to a Roth, Roth SEP, or Roth SIMPLE IRA is subject to the prorated taxation rules described earlier. Part II of Form 8606 is used to account for converted amounts and is used to determine whether any portion of a subsequent distribution of converted assets from a Roth ‘type’ IRA is subject to an additional 10 percent tax for early distribution, in this case sometimes referred to as a recapture tax.

Roth, Roth SEP, or Roth SIMPLE IRA distributions

Distributions from a Roth, Roth SEP, or Roth SIMPLE IRA are reported in Part III of Form 8606. For completing Part III of the form, distributions do not include amounts rolled over (except for qualified disaster distribution repayments), qualified charitable distributions, one-time distribution to fund an HSA, recharacterization, or return of certain contributions. If a Roth ‘type’ IRA distribution is a qualified distribution, it is not necessary to complete Form 8606. If a Roth ‘type’ IRA distribution is not qualified, Form 8606 must be completed to determine whether any portion of the Roth IRA distribution is taxable, which could include an additional 10 percent penalty tax for early distribution. For this purpose, a qualified Roth IRA distribution is a distribution after a Roth IRA owner attains age 59½, after his/her death, or after his/her disability, *and* the five-year taxable period is met. The five-year taxable period begins with the first year for which a Roth IRA contribution was made. Nonqualified distributions would not meet this definition.

Penalties

Without reasonable cause, if an IRA owner fails to file a Form 8606 when required, he/she owes a \$50 penalty. Additionally, if an IRA owner overstates his/her nondeductible contribution amount on Form 8606 without reasonable cause, a \$100 penalty is owed.

Responsibility

completion of Form 8606 when he/she files his/her federal tax return. If an individual is not filing a federal tax return, Form 8606 is filed at the time and place a tax return would otherwise have been filed. It is not an IRA custodian/trustee's responsibility to inform an IRA owner of the need to file Form 8606 or provide the form to an IRA owner. With this said, an IRA owner may not be aware he/she must file Form 8606. For this reason, an IRA custodian/trustee may inform the IRA owner of the requirement and how it relates to the IRA and recommend the IRA owner see a tax professional for assistance.

Conclusion

As Form 8606 is an important IRA related form, an individual needs to understand when to file it with his/her tax return. An IRA owner and his/her tax professional should be aware of what records to keep from year to year and when and how to complete the form. For more information, go to [irs.gov](https://www.irs.gov) and read the Instructions for Form 8606.

For an opportunity to learn more about IRAs and other tax-advantaged accounts, including Health Savings Accounts and Coverdell Education Savings Accounts, consider the Wolters Kluwer IRA Library or on-demand video training offered on a variety of topics. [Go here](#) to learn more about training opportunities available to you or call us at 1-800-552-9408.



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