MEGA-BACKDOOR ROTH

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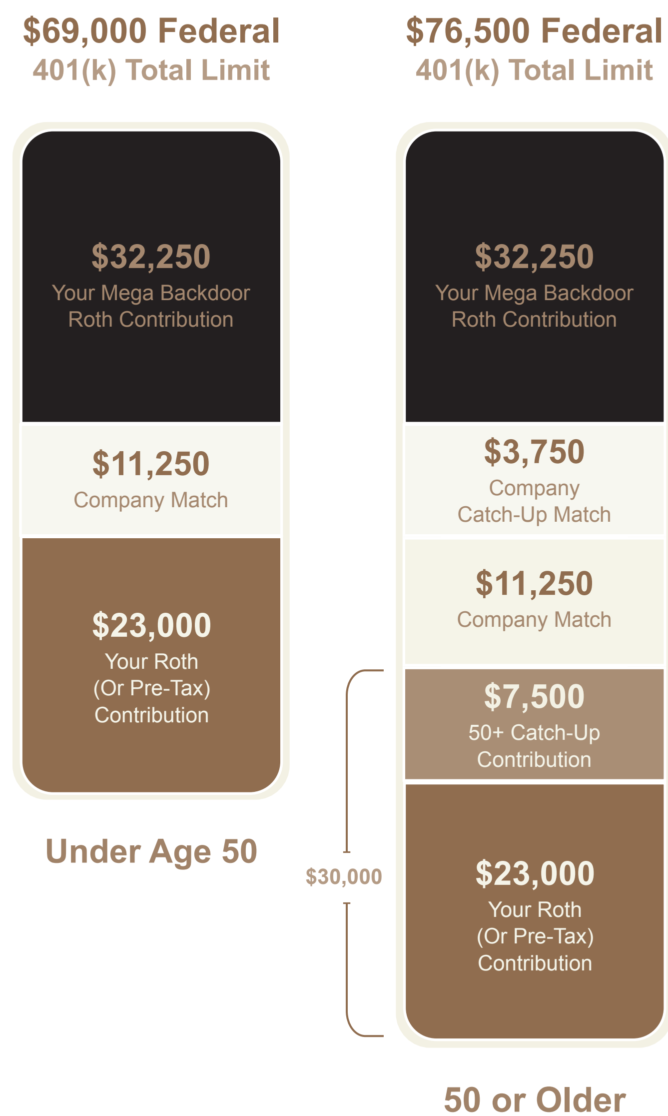
The Mega-Backdoor Roth and Why it Works.

The “mega-backdoor Roth” is a retirement savings strategy that technically allows individuals to make much larger contributions to certain workplace retirement accounts than the annual elective deferral limits. This article discusses how the strategy works.

To utilize a mega-backdoor Roth, the following circumstances must exist:

- The client must be eligible to contribute to a Sec. 401(k) or Sec. 403(b) workplace retirement plan;
- That plan must offer a Roth option for contributions;
- The plan also must allow participants to convert prior contributions to Roth inside the plan, as more than half of plans do, or it must allow participants to roll dollars out of the plan while still participating; and
- For the ultimate mega-backdoor Roth, the plan must also allow what are known as “after-tax contributions,” defined next.



After-Tax Contributions

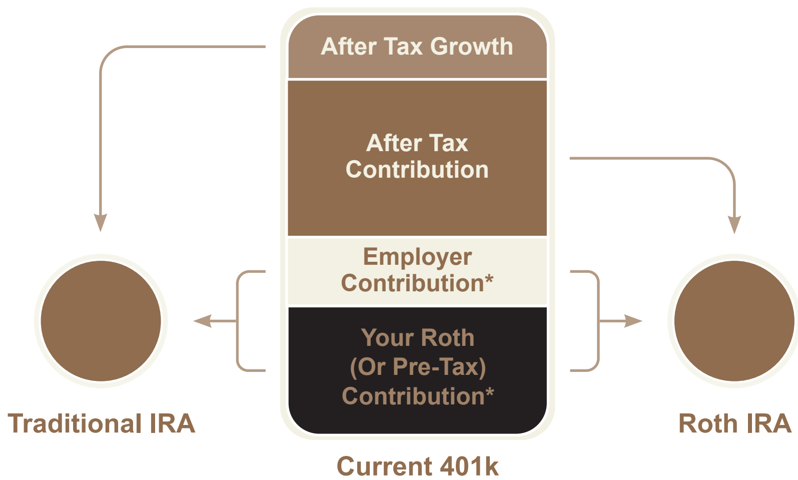
All 401(k) and 403(b) plans allow employees to make pretax elective deferrals up to annual limits ($23,000 for 2024, or $30,500 for those age 50 and older), which is the essence of these accounts. A vast majority of plans also offer workers the option to designate their contributions as Roth.

A third, less-available option for 401(k) and 403(b) accounts is making after-tax contributions above and beyond those designated as Roth. This third “bucket” allows workers to make up the difference between the total of their elective deferrals plus any employer contributions and the IRS maximum allowed contribution amount.

These additional deferrals are not taxable upon withdrawal, but any growth of the funds is taxed upon distribution. Essentially, after-tax contributions are a bit of a hybrid between pretax and Roth contributions.

The mega-backdoor Roth happens when an employee maximizes their after-tax deferral amount, then converts those dollars to Roth within their plan to add to their annual deferrals (or rolls them out while still participating), as described in more detail below. When the conversion is done as soon as administratively possible, the employee effectively excludes the growth of the after-tax dollars from taxation as well. For 2024, the maximum mega-backdoor Roth amount that can be contributed is $69,000 ($76,500 for age 50 and older), which is the IRS maximum allowed for all contribution sources.

Mega-Backdoor Roth Conversion



*Pre-Tax Goes to Traditional and Roth goes to Roth

Calculating the Maximum After-Tax Contribution

To use the mega-backdoor Roth strategy, clients need to know how big an after-tax contribution they can make. As noted, the amount allowed for these additional contributions is the balance remaining between contributions from all sources and that year's IRS maximum-allowed contributions and will depend on how employer matching and profit-sharing contributions work for the client's employer.

Example: If a taxpayer under age 50 earning $200,000 has an employer match of 5% and elects to contribute the maximum of $23,000 for 2024, between her own contributions and her employer's, she would have a combined total of $33,000 contributed to her account. If her plan allows for after-tax contributions, she could contribute up to $36,000 more to get to the $69,000 total allowed for the year.

If she were to then leave the funds classified as after-tax, that $36,000 can be withdrawn tax-free at any time, while any growth on those funds would be taxed upon withdrawal and be subject to the 10% early-withdrawal penalty rules.

Implementing the Mega-Backdoor Roth Strategy

Using the same example, if the taxpayer's 401(k) plan allows her to perform in-plan Roth conversions, where she can elect to move any pretax funds to Roth and pay taxes on any untaxed funds in the year of the conversion, she may elect to do this with her after-tax contributions. Assuming she does this as soon as the contribution is made, that conversion would be tax-free, allowing any future growth of those funds to be tax-free as well.

The "mega" part comes from the fact that, assuming the taxpayer's elective deferral amount of $23,000 was also made as Roth and she elected for her employer match to also be Roth (*matching dollars can -be Roth under a provision enacted in 2022*), she is effectively able to save $66,000 into her Roth 401(k), more than ~10 times the maximum allowed for a Roth IRA

Qualification Checklist

Determine if a Client Qualifies for a Mega-Backdoor Roth

1. Does the client's current 401(k) or 403(b) plan offer a Roth option? If yes
2. Does the plan allow after-tax contributions beyond the annual elective deferral limit? If yes:
3. Does the plan offer the ability to make in-plan conversions to Roth?
4. Does the plan allow for in-service withdrawals of funds, essentially allowing employees to roll over after-tax contributions into an outside Roth IRA at a custodian of their choice?
5. If yes to question 3 or 4, the client may want to consider making what are called "mega-Roth" contributions to the 401(k) or 403(b) by depositing additional funds up to the annual limit before year end, then converting those funds immediately to Roth, which will effectively allow super-funding of the Roth for more tax-free earnings.