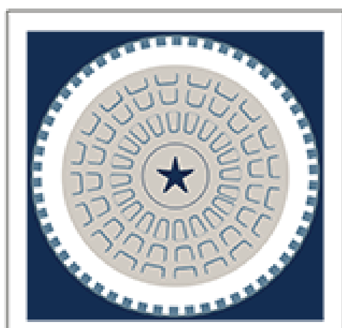

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Roth Contribution Strategies for High Income Earners

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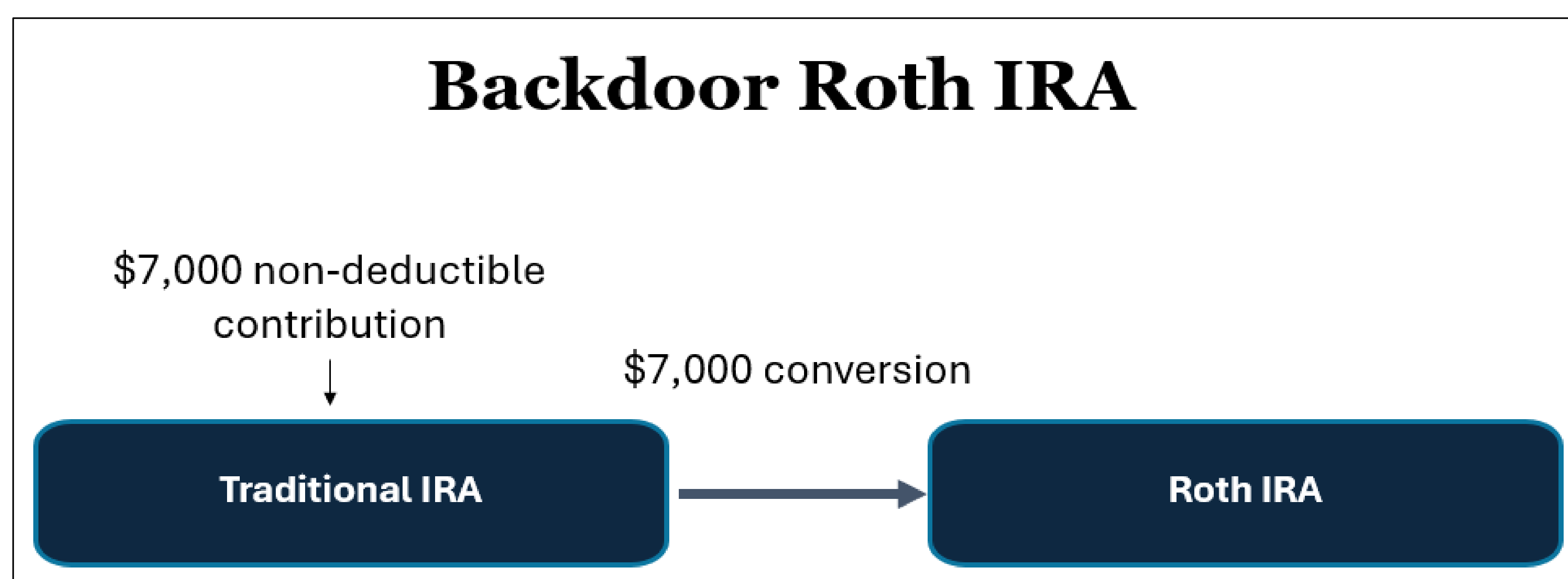
Contributing to Roth accounts is appealing due to their potential for tax-free growth and tax-free distributions for account owners and their beneficiaries, which can help alleviate concerns about higher tax rates in the future. Additionally, Roth accounts are not subject to Required Minimum Distributions (RMDs) for the account owner unlike tax-deferred accounts like the Traditional IRA. For these reasons, making contributions to Roth accounts, when appropriate, can be highly beneficial. However, due to the income limits on contributions to Roth IRAs, high income individuals are often prohibited from participating directly. Similarly, contributions to Roth 401ks are subject to statutory employee contribution limits. The Backdoor Roth and Mega Backdoor Roth Conversion strategies are techniques used to navigate those limitations to allow for more contributions to Roth accounts.

BACKDOOR ROTH IRA

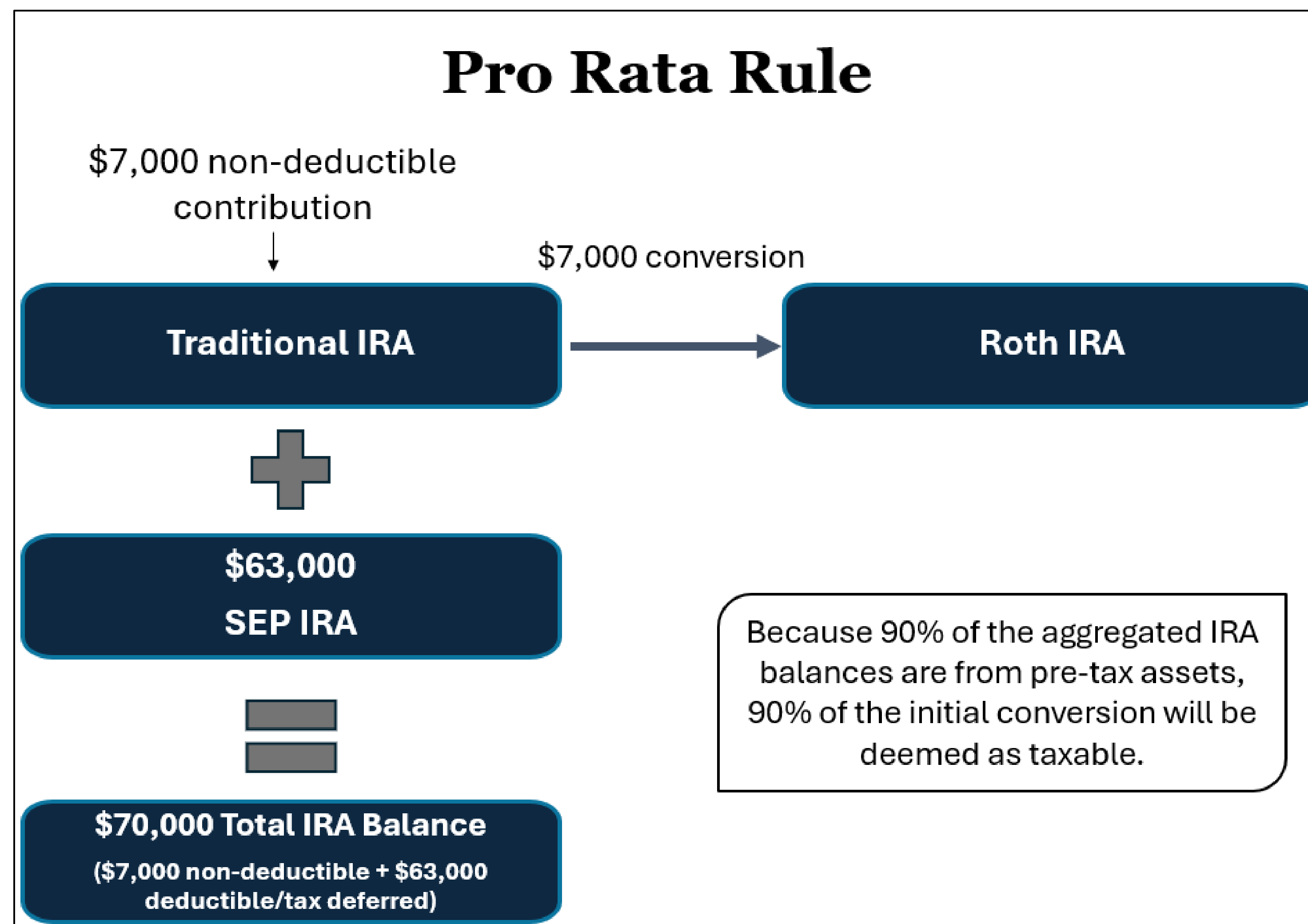
For people wanting to contribute to IRAs, there are a number of potential income limitations. For married couples with earned income in 2024, once adjusted gross income (AGI) exceeds $240,000 ($161,000 for single filers), the maximum Roth IRA contribution of $7,000 (plus $1,000 catchup contributions if over the age of 50) is reduced to zero. However, anyone with earned income can contribute to a Traditional IRA, but the deductibility of that contribution is subject to similar income limitations if you or your spouse participate in a retirement plan at work. See those limitations here - https://www.irs.gov/retirement-plans/ira-deduction-limits. Additionally, there are no income limits to Roth conversions (i.e. taxable transfers from Traditional IRAs to Roth IRA).

With the above in mind, the Backdoor Roth IRA strategy is used by high income taxpayers who would like to make Roth IRA contributions, but exceed the income thresholds for deductible Traditional IRA and direct Roth IRA contributions. Under this method, the high income taxpayer makes a nondeductible Traditional IRA contribution and then converts that amount to a Roth IRA. Because the original contribution to the Traditional IRA is nondeductible, i.e. made with after-tax dollars, the conversion to the Roth IRA is potentially tax-free (but see the pro rata rule below!). In this way, the high income taxpayer has made a contribution to a Roth IRA, albeit in two steps.



But Beware the Pro-Rata Rule!

It is important to be cautious of the Pro-Rata rule when using the backdoor Roth IRA strategy. If a taxpayer has any other Traditional IRAs, rollover IRAs, SIMPLE IRAs, or SEP IRAs, the balances of those accounts are aggregated with the amount converted to the Roth IRA to determine the tax treatment of any distributions and conversions. After-tax contributions are deemed to be distributed on a pro rata basis along with pre-tax assets. Therefore, the existence of any other pre-tax IRA balances will result in a portion of the backdoor Roth conversion being taxable, as seen in the example below. It is important to note that the IRS applies the Pro-Rata rule using the taxpayer's total IRA balances as of the end of the year of the distribution/conversion, not at the time of conversion, and excludes all employer-sponsored retirement plans, such as a 401(k), from the calculation. Additionally, for married couples, the aggregation rules are applied separately for each spouse.



As you can see above, the existence of the pre-tax IRA assets caused 90% of the backdoor Roth conversion to be taxable, effectively limiting the benefit of the transaction. For the transaction to be most beneficial, a taxpayer should have zero balances in pre-tax IRAs in their name at the end of the conversion year. If the taxpayer has pre-tax IRA assets prior to the conversion in their name and would like to utilize the Backdoor Roth IRA strategy, he/she could consider rolling those IRA assets to a non-IRA employer retirement plan if it makes investment sense to do so.

Tax Reporting

After completion of the Backdoor Roth conversion, you should expect to receive a Form 5498 reporting the amount contributed for the year to the Traditional IRA. Additionally, you will receive Form 1099-R reporting the amount distributed/converted from the Traditional IRA, as well as a Form 5498 from the Roth IRA that reports the conversion received. Using those forms, the nondeductible contribution and the calculation of the taxability of the conversion (if applicable) would be reported on Form 8606 with the individual's tax return.

MEGA BACKDOOR ROTH CONVERSION

Building off of the Backdoor Roth IRA strategy, some individuals may be able to put away larger amounts into their tax-free or Roth bucket by utilizing the Mega Backdoor Roth Conversion through their workplace retirement plan.

After-Tax Contributions

To utilize this strategy, the taxpayer must be an active participant in an employer sponsored retirement plan, ex. a 401(k). Additionally, their retirement plan must allow for after-tax contributions to be made beyond the normal employee elective deferral amount ($23,000 in 2024, or $30,500 if age 50 or older and taking advantage of catch-up contributions). Many

retirement plans do not allow for these after-tax contributions in excess of the employee elective deferral amount, so check with the benefits or Human Resources department to verify whether your plan allows for it. It is worth noting that there is an over-arching total contribution limit to employer retirement plans that includes all employee contributions (pre-tax, after-tax and Roth) and employer contributions (profit sharing and matching). That total contribution limit is $69,000 for 2024 ($76,500 if 50 and older).

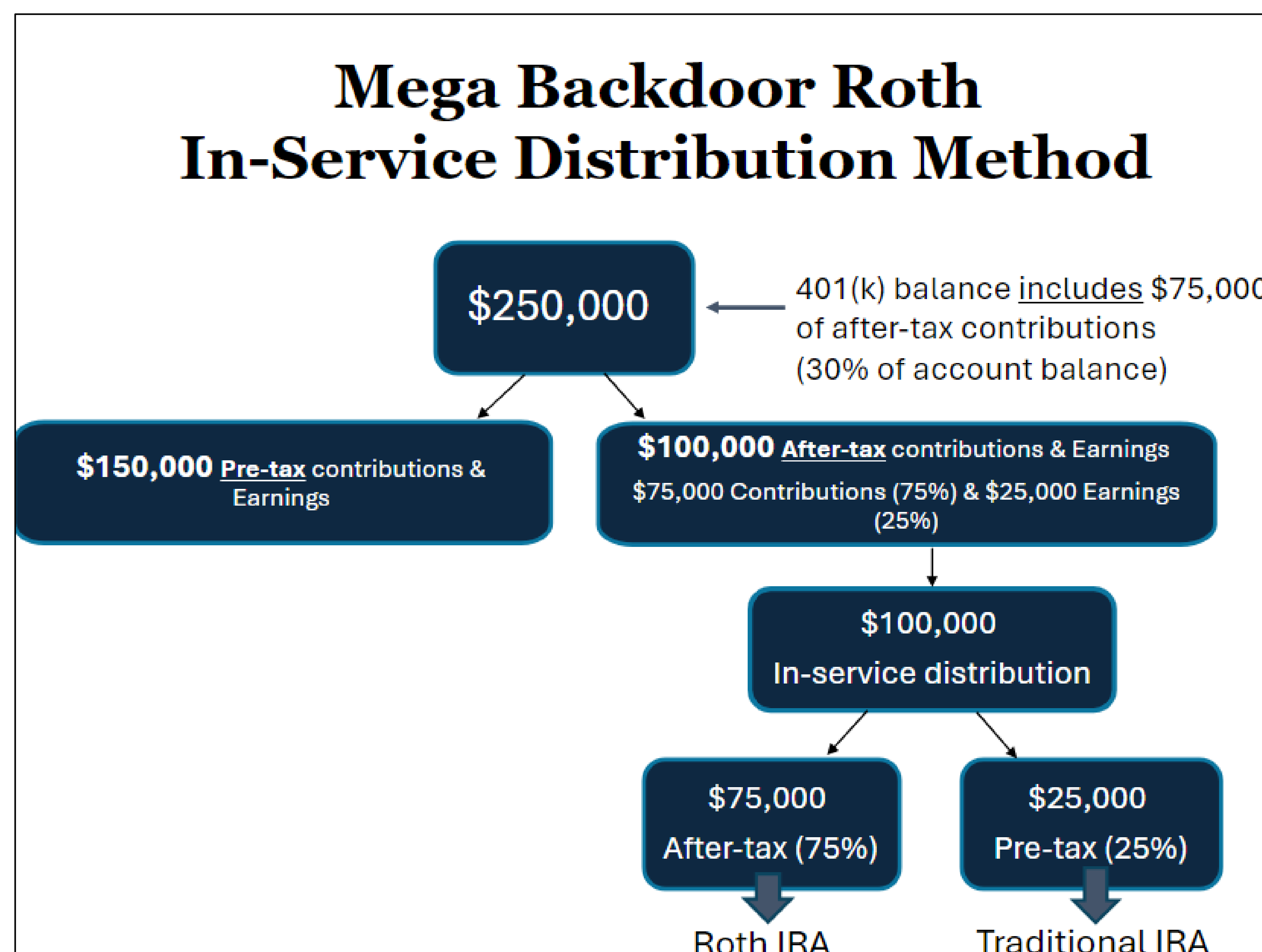
Once the employee elective deferral limit has been reached, if the employee is eligible and if additional savings is desired, the employee can make after-tax contributions subject to the maximums above. Similar to Roth 401(k) contributions, after-tax contributions made inside of a 401(k) do not reduce your taxable income like pre-tax contributions do. However, there is a notable difference between after-tax and Roth 401(k) contributions. With the Roth 401(k), contributions are made with after-tax dollars, but the growth is tax-free and future distributions are tax-free. However, when after-tax contributions are made to your 401(k), the growth of these contributions is tax-deferred and is ultimately taxable as ordinary income when distributed. Thus, by making and investing these contributions, you end up with different tax sources: the after-tax contributions (tax-free when distributed) and the tax-deferred growth on those contributions (taxable as ordinary income when distributed).

The ultimate goal of Mega Backdoor Roth strategy is to convert the after-tax dollars to a Roth account so that any future growth will be tax-free instead of tax-deferred. This can be accomplished in a few different ways, depending on what your retirement plan allows.

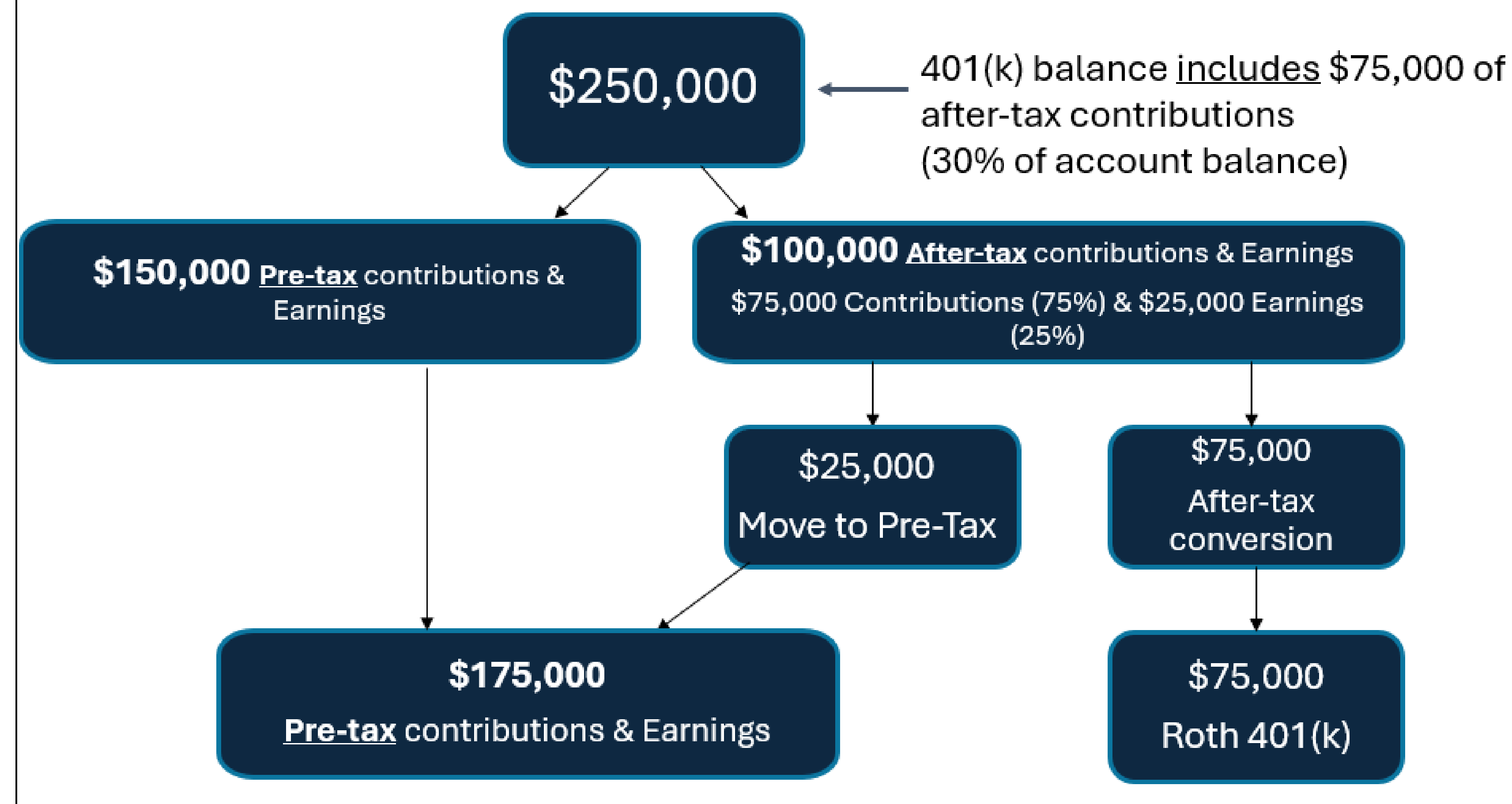
Conversion Logistics

When you convert your after-tax dollars to a Roth account, you may be able to do so within your 401(k) or you may need to roll the contributions out of the employer plan and into a Roth IRA instead. Typically, these options are referred to as an in-plan Roth conversion and/or an in-service distribution. You'll want to consider which options are available to you before proceeding.

If you withdraw the after-tax contributions from the 401(k) wrapper by utilizing the in-service withdrawal approach, make sure to pay attention to any earnings or growth that is associated with those contributions. Recall the earnings are tax-deferred in nature, so those funds would need to be deposited in a Traditional IRA while the after-tax contributions would be deposited in a Roth IRA. Alternatively, you could convert the tax-deferred earnings to Roth, though you would be taxed on the amount converted as income in the current tax year. Be aware that rolling out the tax-deferred earnings into a Traditional IRA could limit your ability to make the normal Backdoor Roth IRA contributions, making you subject to the Pro-Rata rule moving forward.



If you convert the after-tax contributions to the Roth portion inside of the 401(k) by utilizing the in-plan Roth conversion approach, you're moving dollars from one tax bucket to another inside of the same account. In this case the after-tax contributions are moved to the Roth 401(k) portion of the account, and the earnings would be added to the pre-tax portion.



Whether you implement the Mega Backdoor Roth strategy via an in-plan conversion or an in-service withdrawal, if you are making continued after-tax contributions you'll want to periodically convert those amounts to a Roth account so that the contributions can be growing on a tax-free basis as soon as possible.

Tax Reporting

When performing the Mega Backdoor Roth Conversion, you should receive a form 1099-R from your retirement plan in the year the transaction was executed that should be included on your tax return. If executed correctly and only after-tax contributions were converted to Roth, there should be no tax consequences from the transaction.

CONCLUSION

The Backdoor Roth IRA and the Mega Backdoor Roth Conversion are both great strategies to help save more dollars into tax-free accounts. They are especially beneficial for those who may not be able to contribute to Roth IRAs directly because of income limitations and for those who want to get even more employer retirement plan contributions into tax-free accounts. However, these strategies can be fairly complex from a logistical and tax reporting standpoint.

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