Backdoor and Mega-Backdoor Roth

The Roth IRA was introduced under the Taxpayer Relief Act of 1997 and is named after its chief legislative sponsor, Senator William Roth of Delaware. In exchange for giving up a current income-tax deduction potentially afforded by a traditional IRA, investors contributing to a Roth IRA do so with after-tax dollars. Assuming all requirements are met, withdrawals from Roth IRAs are tax free. This contrasts with contributions to a traditional IRA which, in most cases, are made with pre-tax dollars and withdrawals are taxed at ordinary income rates.

Roth IRAs are subject to income eligibility requirements. For the 2023 tax year, single taxpayers with a modified adjusted gross income (MAGI) in excess of $153,000, and married taxpayers filing jointly in excess of $228,000 are completely phased out from directly contributing to a Roth IRA.

For taxpayers whose MAGI exceeds the limits, and who are precluded from making a tax-deductible traditional IRA contribution because they are participating in an employer sponsored retirement plan, there may be another way to contribute to a Roth IRA using a strategy called backdoor Roth contributions. To do so, you make a non-deductible contribution to a traditional IRA first, then convert that amount to a Roth IRA. If the contribution and subsequent conversion occur with no growth in the account, then there is no tax due.

In order to be eligible to maximize your contribution to a traditional or Roth IRA, you must have earned income equal to or in excess of the limit, which is $6,500 in 2023 with an additional $1,000 for taxpayers aged 50 or older.

Taxpayers who have other pre-tax IRA accounts will need to be mindful of the IRA aggregation rules, which state that all IRA dollars are considered comingled even if in separate accounts. This means that even if you open a new traditional IRA to contribute nondeductible dollars for the purpose of a backdoor Roth contribution, you would not be able to separate those nondeductible dollars from any deductible dollars in another traditional IRA. However, the IRA aggregation rules do not apply to qualified plans such as a 401(k).

There are a couple of options if you have nondeductible IRA balances and are looking to increase Roth balances using backdoor contributions. First, if you are employed and your employer provided retirement plan allows for reverse rollovers (e.g., IRA to a qualified plan) then you could consolidate those funds into the qualified plan and proceed. Second, depending on the size of the traditional IRA, it may make sense to pay income taxes on the balance by converting to Roth and then continue with backdoor contributions.

Mega-Backdoor Roth

An even more attractive opportunity exists for those who are employed and, crucially, their employer's qualified plan allows after-tax contributions. This strategy is referred to as the "mega-backdoor Roth" due to the much larger amount investors can direct toward a Roth. The maximum that can be contributed to a qualified plan in 2023 is $66,000, or $73,500 if you're over 50 years of age. This amount includes pre-tax or Roth contributions, employer match, employer profit-sharing contributions and after-tax contributions, if allowed.

It is advisable to convert the after-tax contribution to Roth as quickly as possible to avoid any additional taxation that would occur if there was appreciation. Ideally, the qualified plan would allow in-service Roth conversions to convert the pre-tax dollars within the account. If the plan does not allow this, you could implement an in-service rollover to a Roth IRA. Most plans maintain a minimum age requirement of 59 ½ for existing employees to perform an in-service rollover, although some are now allowing plan participants under 59 ½ to roll out only their after-tax dollars.

Finally, for those contemplating their estate planning objectives, Roth IRAs are among the most powerful wealth transfer vehicles as they are not exposed to required minimum distributions during your lifetime and maintain their tax-free status for a period of 10 years once inherited by your heirs. The backdoor Roth and the newly popular mega-backdoor Roth are two ways to increase your tax-advantaged retirement savings under the correct circumstances.

A combination of strategically funded retirement accounts with different tax treatment provides a hedge against variability between current and future tax rates. The power of compounding interest in a tax-free bucket is a compelling reason to endure the complexity of these strategies.

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