

Skloff Financial Group

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Question of the Month

By Aaron Skloff, AIF, CFA, MBA

Q: We read ‘How to Complete a Backdoor Roth IRA’. What other strategies can we use to build our Roth savings?

The Problem — Building Tax-Free Savings

Roth Individual Retirement Accounts (IRAs) are highly desirable for retirement savers because they allow for tax-free growth, tax-free withdrawals, and are exempt from required minimum distributions (RMDs). Fortunately, the Backdoor Roth IRA helps build tax-free savings. Unfortunately, annual contributions are capped at \$7,500 for those under age 50, and \$8,600 for those age 50 and over.

The Solution — Mega Backdoor Roth

A Mega Backdoor Roth is an advanced 401(k) strategy that lets high-income earners contribute substantially more to a Roth account than standard limits allow. Internal Revenue Code (IRC) Section 402(g) sets annual limits for standard employee contributions (deferrals) to 401(k)s per year: \$24,500 for participants under the age of 50, \$32,500 for ages 50–59 or 64+, or \$35,750 for ages 60–63. IRC Section 415(c) sets annual contribution limits for combined employee and employer (i.e., matches and profit sharing) contributions to 401(k)s per year: \$72,000 for participants under the age of 50, \$80,000 for ages 50–59 or 64+, or \$83,250 for ages 60–63.

In addition to your standard pre-tax (Traditional) or after-tax (Roth) 401(k) employee contributions and employer matches and/or profit-sharing contributions, you can make after-tax contributions to maximize your 415(c) annual limit. The 415(c) limit is almost triple the 402(g) limit for those under the age of 50. **The problem: while the growth on Roth contributions is tax-free upon withdrawal, the growth on after-tax contributions is subject to income taxes upon withdrawal.**

The Mega Backdoor Roth with Automatic In-Plan Conversions. By utilizing a Mega Backdoor Roth with Automatic In-Plan Conversions, you solve this problem. If you immediately convert after-tax contributions to Roth through an in-plan conversion (or to a Roth IRA as an in-service withdrawal), the growth on those after-tax contributions becomes tax-free upon withdrawal. If you delay the conversion, the growth on your contributions will be subject to income taxes at the time of the conversion. Therefore, if you establish an automatic in-plan conversion to Roth with each after-tax contribution before any growth occurs, you can effectively replicate the benefits of a Roth contribution using after-tax dollars to achieve tax-free growth and tax-free withdrawals.

The Mega Backdoor Roth: Step-by-Step Process

Step 1 – Make Pre-Tax and/or Roth 401(k) Contributions. Contribute the optimal amount to maximize employer matches.

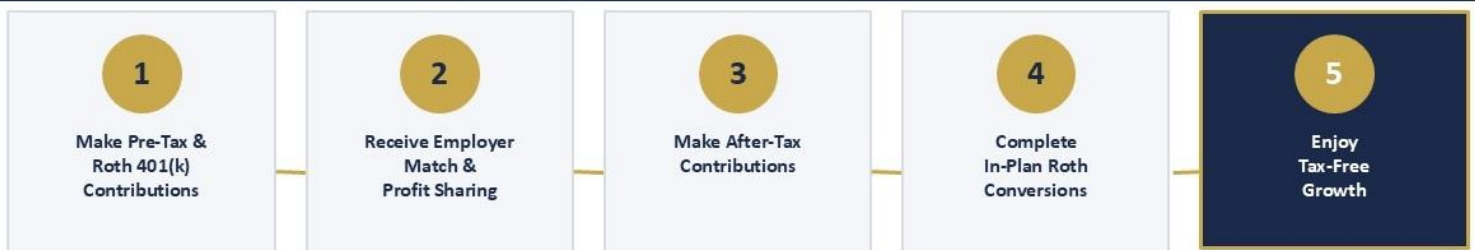
Step 2 – Receive Employer Matches and Profit Sharing. Employer contributions count towards the 415(c) limit.

Step 3 – Make After-Tax Contributions. Contribute after-tax dollars to fill the remaining 415(c) gap.

Step 4 – Complete In-Plan Roth Conversions. Auto-convert upon each contribution to preserve tax-free growth.

Step 5 – Enjoy Tax-Free Growth and Tax-Free Withdrawals. Gains and withdrawals are tax-free for you and your heirs.

The Mega Backdoor Roth: Step-by-Step Process



Have Your Cake and Eat It Too. You can complete a Backdoor Roth IRA and Mega Backdoor Roth in the same year.

Not All 401(k) Plans Allow Mega Backdoor Roth or Automatic In-Plan Conversions. While the IRC allows for the Mega Backdoor Roth, some employers are not aware of or do not permit this strategy. Furthermore, not all plans offer automatic in-plan conversions.

Action Step — Complete a Mega Backdoor Roth

Work closely with your Registered Investment Adviser to evaluate your Mega Backdoor Roth opportunities.

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