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WHAT IS A MEGA BACKDOOR ROTH?

By: C. Hicks, S. Steinberg, & H. Alberstadt - April 17, 2023

Key points

- A mega backdoor Roth involves converting after-tax 401(k) contributions to a Roth IRA.
- High earners often use the strategy after maxing out other retirement savings options.
- To use a mega backdoor Roth, your employer-sponsored plan must allow after-tax contributions and in-service withdrawals.

Retirement is expensive and only getting more so. While the IRS raised contribution limits on retirement plans for 2023, that increase may not be enough if you're close to retirement or planning an expensive post-employment lifestyle. So what's a high roller to do?

One strategy individuals with high incomes can leverage is the mega backdoor Roth. This special type of 401(k) rollover benefits people who earn too much to contribute to a Roth individual retirement account, or IRA, due to income limits. Essentially, they can use a mega backdoor Roth to roll over up to $43,500 to a Roth IRA in 2023.

The mega backdoor Roth is the "Rolls-Royce" of Roth conversions, says Peter Casciotta, owner of Asset Management & Advisory Services of Lee County in Cape Coral, Florida. But it isn't for everyone. Nor should it be undertaken alone.

"When it comes to mega backdoor Roths, you should consider seeking professional advice from your team of advisors to help ensure you do not experience any future unexpected surprises," Casciotta says.

What is a mega backdoor Roth?

A mega backdoor Roth allows you to roll over money from your 401(k) to a Roth IRA.

"A mega backdoor Roth 401(k) conversion can be a useful tool if you are trying to accumulate some tax-free interest on your investments as part of your portfolio," says Jeff Busch, partner and investment advisor representative at Lift Financial in South Jordan, Utah. "However, the mega backdoor Roth may not work for everyone."

For this strategy to work, your employer-sponsored traditional 401(k) plan must allow both after-tax contributions, which we explain below, and in-service withdrawals, which let you take money out of your 401(k) while you're still working for the company.

Even if your plan allows after-tax contributions and in-service withdrawals, a mega backdoor Roth may not be the right move for your tax situation.

How a mega backdoor works

To understand how a mega backdoor Roth works, you first need to understand how 401(k) contributions work. There are four types:

- Pretax contributions. Money is deducted from your paycheck and put straight into your 401(k) before taxes are taken out. The money grows tax-deferred in your 401(k) until you withdraw it during retirement, at which point you pay income taxes on contributions and earnings.
- Roth contributions: Roth 401(k)s operate much like Roth IRAs. You make after-tax contributions, meaning the IRS gets its cut before the money goes into your account, and withdraw contributions and earnings tax-free in retirement.
- After-tax contributions. Like Roth contributions, these contributions are made with after-tax dollars. You withdraw contributions tax-free in retirement but pay income taxes on earnings. Not all plans allow after-tax contributions.
- Employer contributions. Your employer may match some of the contributions you make to your 401(k). Note that after-tax contributions may not be eligible for an employer match. Employer matching contributions do not reduce the amount of traditional or Roth contributions you can make to your 401(k), but they do reduce how much after-tax money you can add to the account.

These combined contributions cannot exceed $66,000, or $73,500 if you're 50 or older, for 2023. Up to $22,500, or $30,000 if you're 50 or older, of that amount can be pretax and Roth 401(k) contributions combined. Next comes employer contributions, and then you can fill the rest of the $66,000 limit with after-tax contributions.

The table below provides a visual representation.

401(k) contribution limits

Example: Say you're 45 and you contribute $22,500 of pretax money to your 401(k) in 2023. If your employer makes a matching contribution of $1,500, you can put another $42,000 ($66,000 – $22,500 – $1,500) into your 401(k) in after-tax contributions. It's those after-tax contributions that can be used for a mega backdoor Roth.

A mega backdoor Roth using the above example would look like this:

- Step 1. Make a $42,000 after-tax contribution to your 401(k).
- Step 2. Roll that contribution into a Roth IRA, or a Roth 401(k) if your employer offers one.

For the best results, you want to roll over your after-tax contributions as soon as possible to avoid the accrual of earnings. That's because, while you can roll over your after-tax contributions tax-free, any earnings will be taxed in the conversion.

One more caveat before you attempt a mega backdoor Roth: The IRS has a pro rata rule on 401(k) distributions that requires you to withdraw proportional amounts of pretax and after-tax contributions if your account balance contains both.

Example: Say your 401(k) balance is $100,000 and consists of $80,000 in pretax money and $20,000 in after-tax money. You can't withdraw only the pretax amount or only the after-tax amount. Any distribution, including a rollover, must also consist of 80% in pretax dollars and 20% in after-tax dollars. So when you do your mega backdoor Roth IRA rollover, you'll also need a traditional IRA to roll the pretax dollars into.

Backdoor Roth vs. mega backdoor Roth

Backdoor Roths accomplish a similar goal to mega backdoor Roths but on a smaller scale. With a backdoor Roth, you can get around the income limits on Roth IRAs by contributing to a traditional IRA, which has no income limits, and then converting it to a Roth IRA. This is generally simpler than a mega backdoor Roth, as you don't have to worry about pesky 401(k) distribution rules or rely on your employer allowing after-tax contributions and in-service withdrawals.

The downside to a backdoor Roth is that you're limited by the annual IRA contribution limits, which are considerably lower than the annual 401(k) limits. For 2023, the IRA contribution limit is $6,500, or $7,500 if you're 50 or older.

How do you know if you can do a mega backdoor Roth?

Busch says there are a couple of things you'll need to know about your 401(K) plan before you can determine if a mega backdoor Roth is an option for you:

1. The amount of your employer match, as it gets subtracted from the after-tax contribution you can make.
2. Whether your 401(k) plan allows in-service distributions, which Busch calls "the key to making this strategy work."

If your plan doesn't allow in-service distributions, you won't be able to complete the conversion until you leave the company. At that point, your after-tax contribution may have accrued earnings, which would be taxed at the time of the conversion. In other words, prepare for a potentially hefty tax bill.

If you don't know whether your plan allows in-service distributions, you can ask your HR department.

Contribute to a Roth 401(k)

If your employer offers a Roth 401(k), a simpler option is contributing directly to that, Busch says. The downside is you will be limited to the annual 401(k) elective deferral contribution limit, which is $22,500 in 2023, or $30,000 if you're 50 or older.

Max out a Roth IRA

If your income allows, you can contribute to a Roth IRA directly instead of taking the backdoor approach. Single filers under age 50 must earn less than $138,000 in 2023 to contribute the full $6,500 to a Roth IRA. If you're married and file jointly, your income must be below $218,000 for the year to make the full contribution.

Contribute to a health savings account

Another way to increase your tax-advantaged savings is through a health savings account, or HSA, if your health plan allows.

HSAs allow you to contribute pretax dollars — up to $3,850 for individual coverage and $7,750 for family coverage, plus a $1,000 catch-up contribution if you're 55 or older — for use toward medical expenses. Withdrawals are then tax-free when used for qualified medical expenses.

The money in an HSA rolls over from year to year and can be invested while it's in the account. So, in effect, an HSA can act like an extension of your retirement savings and can come in handy for medical expenses, especially considering a retired couple age 65 in 2022 needs approximately $315,000 to cover health care costs in retirement, according to research by Fidelity Investments.

The moral of the story is that any savings are better than no savings. The fact that you're even considering a mega backdoor Roth means you deserve a pat on the back.