Mariner
WEALTH ADVISORS

High Earner? Consider a Backdoor Roth or Mega-Backdoor Roth

The IRS places income limits on who can contribute to a Roth IRA. As an alternative, high earners can convert traditional IRA or 401(k) funds into a backdoor Roth or mega-backdoor Roth as part of a retirement savings strategy.

There are two ways you can execute on these advanced Roth strategies:

- Make a nondeductible contribution to a traditional IRA and then subsequently convert it to a Roth IRA. For 2023, you can contribute up to $6,500 to a traditional IRA or $7,500 if you're age 50 or older.
- If your company 401(k) plan or other retirement plan allows conversions (talk to your employer and wealth advisor about eligibility rules), you can roll over your account to a Roth IRA or convert inside the plan to a Roth 401(k). Keep in mind you will need to pay taxes on any earnings included in the conversion. However, you won't generally need to pay taxes on contributions you convert, as those amounts have already been taxed. Please meet with your advisor or tax professional for advice on the potential tax impacts.

Dealing With Income Limits on Roth IRAs

In 2023, if your marginal adjusted gross income (MAGI) is $153,000 or higher and you're single ($228,000 if married filing jointly),[1] then you can't contribute directly to a Roth IRA, but these income caps don't apply to backdoor Roth IRAs.

Potential Tax Savings With Backdoor Roths

As long as requirements are met, your future retirement distributions from the Roth retirement accounts are not taxable. One of the advantages of a backdoor Roth IRA is that you pay a smaller amount of taxes upfront on any converted pre-tax funds and then withdrawals are tax free. This tax benefit is greatest if you expect tax rates to rise in the future or think that your taxable income will be higher in years when you are retired.

Tax Implications to Consider

Before completing a backdoor Roth IRA, work with your wealth advisor to project the tax implications. One of the most important rules relevant to the backdoor Roth conversion is the "pro-rata" rule, which could have unintended tax consequences if not evaluated properly. If you already have balances in existing traditional IRAs, you should be aware that a larger portion of the amount that you are converting to a Roth would be taxable, and you would need to do a calculation to determine that taxable portion based upon the balances in all your traditional IRAs.

What to Know About a Mega-Backdoor Roth

To take advantage of this strategy, your employer must allow after-tax contributions to a 401(k). Your employer must also have a Roth 401(k) with the option for an in-plan Roth conversion and/or allow in-service withdrawals, which means taking a distribution from your 401(k) while you're still employed. If these requirements are met, you can follow these three steps:

- First, max out your normal 401(k) contributions.
- Next, if allowed, contribute after-tax dollars to your 401(k) up to the overall limit of $66,000 in 2023 ($73,500 if you are age 50 or older).[2] The maximum contribution includes any contributions made by your employer.
- Lastly, make an irrevocable transfer of the after-tax funds into a Roth 401(k)/IRA as soon as possible since any earnings will be taxed in a rollover/conversion.

5-Year Rule Applies

Whether you put money into a backdoor Roth or mega-backdoor Roth, the account must be open for five years before you can withdraw both contributions and earnings tax free.

Advantages of Both Types of Roths

The backdoor Roth IRA is optimal for high earners who want to fund additional dollars for retirement and take advantage of the tax-free growth and withdrawals of a Roth retirement account but don't have access to an employer retirement plan that allows a mega-backdoor Roth opportunity.

Meanwhile, the mega-backdoor Roth is most suitable for high earners who can contribute beyond the typical contribution limit of an IRA, pre-tax 401(k) or Roth 401(k) and want to reap the benefits of tax-free retirement withdrawals.

Work With Your Advisor

When it comes to wealth planning, higher incomes typically involve greater complexity. Be sure to meet with your wealth advisor and tax professional to determine whether a backdoor Roth or mega-backdoor Roth is appropriate for your situation.

For more information visit: marinerwealthadvisors.com

Sources:

[1]"Amount of Roth IRA Contributions You Can Make"

[2]"401(k) and Profit Sharing Plan Contribution Limits"