Time is Running Out to Execute Backdoor and Mega Backdoor Roth Conversions

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It's not the law of the land.

But it could be. And if it does become the law of the land, now would be a good time to consider doing a backdoor Roth IRA conversion and/or a mega backdoor Roth IRA conversion.

If you're unfamiliar with such tactics, let's review the basics.

The backdoor Roth IRA

Let's say you make too much money to contribute to a Roth IRA. How would you know that?

This IRS table is a good place to start. It shows whether your contribution to a Roth IRA is affected by the amount of your modified AGI as computed for Roth IRA purpose.

If your filing status is...	And your modified AGI is...	Then you can contribute...
married filing jointly or qualifying widow(er)	< $198,000	up to the limit
	> $198,000 but < $208,000	a reduced amount
	> $208,000	zero
married filing separately and you lived with your spouse at any time during the year	< $10,000	a reduced amount
	> $10,000	zero
single, head of household, or married filing separately and you did not live with your spouse at any time during the year	< $125,000	up to the limit
	> $125,000 but < $140,000	a reduced amount
	> $140,000	zero

So, if you make too much money to contribute to a Roth IRA, don't despair. There's a backdoor way into funding a Roth IRA. In essence, you make a non-deductible (after-tax) contribution to a traditional IRA and then immediately convert those dollars to a Roth IRA.

Assuming there's no earnings on the after-tax dollars, there will be no due on the conversion.

But you do have to be careful when doing this. "You cannot 'cherry pick' the after-tax dollars in your IRA and only convert those," according to Andy Ives, an IRA analyst with Ed Slott & Co. "If you have any pre-tax (deductible) dollars in any IRA, SEP or SIMPLE plan, those dollars must be considered under the pro-rata rule. Pro-rata dictates that any conversion will include a proportionate share of pre- and after-tax dollars. The only way a Roth conversion can be 100% tax-free is if you have no pre-tax dollars in any of your IRAs, SEP or SIMPLE plans."

When in doubt, consult with an IRA expert such as those found in Ed Slott's Elite IRA Advisor Group.

The mega backdoor Roth IRA conversion

So, the mega backdoor Roth IRA conversion works a bit like the regular backdoor Roth IRA conversion. But instead of funding a traditional IRA with after-tax dollars, you would fund your 401(k) with after-tax dollars.

It's a multi-step process according to Matt Stratman of Western International Securities, Ryne Vickery of Buckingham Strategic Wealth, and Joseph DiSalvo and Marie Madarasz.

1. Check whether your 401(k) plan allows for after-tax voluntary contributions and in-service distributions out of the 401(k) plan. If you're not sure, check with your plan administrator or human resource manager. If you can't make after-tax contributions or you can't execute an in-service distribution, there's no need to read on.

2. Next, contribute the maximum to your traditional 401(k). That would be $19,500 in 2021 or $26,000 if you are over the age of 50.

Next, start contributing after-tax dollars to your 401(k). How much can you contribute after-taxes voluntarily? According to the IRS, annual contributions to all of your accounts maintained by one employer (and any related employer) - this includes elective deferrals, employee contributions, employer matching and discretionary contributions and allocations of forfeitures, to your accounts, but not including catch-up contributions - may not exceed the lesser of 100% of your compensation or $58,000 for 2021 or $64,500 if you include catch-up contributions.

That means you could contribute an extra $38,500 in after-tax money to your 401(k).

3. After contributing your after-tax money, you can then take an in-service withdrawal of that amount from your 401(k) and move it into your Roth IRA.

Now, it all sounds easy enough on paper. But the rules are complicated and there's plenty that can go wrong here. For starters, you'll want to make the in-service withdrawal as quickly as possible, because any growth of your after-tax contributions will be counted in your pre-tax bucket, NOT the Roth bucket, says Vickery. And, it should go without saying that you'll need comprehensive records of all transactions.

And Stratman says, you would invest the after-tax money in your 401(k), best case, for at least a year before converting to a Roth account. That way you avoid the risk of having the IRS view this as a single transaction, which could result in a 6% excise. Of course, with the new law looming you may not have that option.

Also, the IRS says that you are NOT able to roll ONLY after-tax amounts out of your retirement plan, says Vickery. You must take out a pro-rata portion of both pre-tax and after-tax amounts for the transaction to be in good standing.

However, the IRS does allow you to split the rollover between a Roth and traditional IRA, says Stratman. This means that you can send the pretax portion of the distribution (the earnings) to a traditional IRA and the after-tax portion to a Roth IRA, resulting in a tax-free rollover and conversion.

Act now

Of note, President's Biden's proposed American Families Plan Act (AFPA) would prohibit conversions of after-tax dollars held in retirement accounts (both IRAs and employer-sponsored retirement plans, such as 401(k)s), beginning in 2022. So, assuming the AFPA becomes the law of the land, consider doing your backdoor contributions and conversions in 2021. By the way, one of the best overviews of AFPA can be found here.