The Mega Backdoor Roth IRA

Matt Becker, CFP®

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If you're already maxing out all of your retirement accounts and you'd like to save even more money in a tax-advantaged way, this one's for you.

The Mega Backdoor Roth IRA – coined by Jim Dahle at [The White Coat Investor] – is a strategy that allows you to contribute up to $36,000 per year to your Roth IRA, on top of your other retirement savings, without any income restrictions.

And if your spouse is eligible too, you could potentially put a total of $72,000 per year into Roth IRAs between the two of you. That's a lot of money that will never be taxed ever again.

Interested?

Now, the truth is that most people won't be able to take advantage of the Mega Backdoor Roth IRA. It's enough of a struggle for most people to max out their regular retirement accounts, let alone save more. And many 401(k) plans don't have the attributes that make this strategy possible anyway.

There's also a lot to this strategy, including logistics that will depend on your 401(k) and IRA providers. This guide explains how it works generally, but it doesn't lay out all the specific steps *you* will have to take or the specific obstacles you might face.

Still, if you have extra money to save and want to find a tax-advantaged way to do it, it's definitely worth looking into the Mega Backdoor Roth IRA. If you're eligible, it can provide a huge boost to your long-term savings.

Before diving in...

Your ability to take advantage of the Mega Backdoor Roth IRA depends on your ability to first make a certain type of 401(k) contribution, one that most people never even consider.

So before diving into the specifics of the Mega Backdoor Roth IRA, let's take a step back and talk about the four types of contributions you can make to your 401(k).

1. Traditional employee contributions

These are the contributions that most people make to their 401(k)s. Your contributions are tax-deductible, the money grows tax-free inside the 401(k), and your withdrawals are taxed as ordinary income in retirement.

2. Roth employee contributions

Some 401(k)s allow you to make Roth contributions that are not deductible, but which grow tax-free inside the 401(k) and can be withdrawn tax-free in retirement, just like a Roth IRA.

Between your Traditional and Roth contributions, you're currently allowed to contribute a total of $18,000 per year to your 401(k). The contribution limit increases to $24,000 if you're age 50 or older.

3. Employer contributions

Your employer often contributes money to your 401(k) in addition to your contributions. Typically this comes in the form of a matching contribution, but in some cases your employer might make non-matching contributions as well.

4. Non-Roth after-tax employee contributions

This is the type of 401(k) contribution that most people don't know about, and it's also the key to being able to take advantage of the Mega Backdoor Roth IRA.

Some 401(k) plans, but not all, allow employees to make **non-Roth after-tax contributions** in addition to the $18,000 they're allowed to contribute as Traditional or Roth contributions. These after-tax contributions have a few key characteristics:

- Your contribution is non-deductible and the amount you contribute will never be taxed.
- The *earnings* on those contributions grow tax-free, but are taxed as ordinary income when they're withdrawn.
- For 2017, your maximum annual after-tax contribution is calculated as: $54,000 - total employee contribution - total employer contribution.

This is the type of 401(k) contribution that allows for the Mega Backdoor Roth IRA. And with that context, let's talk about how the strategy actually works.

The quick version of the Mega Backdoor Roth IRA

We'll get into the detailed steps below, but it will be helpful to go through them with a basic understanding of how the Mega Backdoor Roth IRA works.

So here's the quick version:

1. You contribute non-Roth after-tax money to your 401(k).
2. You roll that money over to a Roth IRA, either immediately or when you leave your company.
3. Once that money is inside a Roth IRA, it will never be taxed again.

Because there are no income limits on rollovers, and because you can contribute a LOT of non-Roth after-tax money to your 401(k) that can then be rolled over, it's an effective way for high-income earners to save a significant amount of money tax-free beyond the traditional routes.

How the Mega Backdoor Roth IRA works

Now let's get into the details.

There are four main steps to the Mega Backdoor Roth IRA, though the fourth step depends on the specifics of your 401(k) plan.

Here's how it works.

1. Max out other tax-advantaged accounts first

Before even thinking about doing the Mega Backdoor Roth IRA, you should max out all of your other tax-advantaged investment accounts. Namely, your regular 401(k) contributions, regular IRA contributions, a health savings account, and even a regular Backdoor Roth IRA.

Those are simpler contributions with similar tax benefits, so it makes sense to handle them first.

2. Find out if your 401(k) allows for the Mega Backdoor Roth IRA

If you still have money you'd like to invest after maxing out your other tax-advantaged accounts, it's time to figure out whether you're eligible to do the Mega Backdoor Roth IRA.

It all depends on what types of contributions your 401(k) allows and how it allows you to access those contributions. Here are the three things you need to look for. You can figure out if 401(k) allows for these by checking your **summary plan description** or asking your plan administrator.

1. **The ability to make non-roth after-tax contributions** - This is the most critical piece. You simply have to be able to make these contributions in order to take advantage of this strategy, and not all 401(k) plans allow them.

2. **The ability to make in-service withdrawals** - This is helpful, but not necessary. Many plans allow you to withdraw your after-tax contributions even while you're still with the company. This allows you to take maximum advantage of this strategy since you can get your contributions into a Roth IRA immediately. But you can still do the Mega Backdoor Roth IRA without this feature.

3. **After-tax contributions are kept in a separate sub-account** - Again, this is helpful but not necessary. Ideally, your after-tax contributions and their earnings are kept in a separate sub-account from your other 401(k) contributions. Without this, you can't take advantage of in-service withdrawals because you wouldn't be able to rollover *just* the after-tax piece of your 401(k), meaning you'd face a much bigger and unnecessary tax hit. (Details on this here.)

As long as your 401(k) allows for non-Roth after-tax contributions, you can move to Step 3. If not, you unfortunately can't take advantage of the Mega Backdoor Roth IRA.

If your 401(k) also allows for in-service withdrawals AND keeps after-tax contributions in a separate sub-account, you can then use Step 4a. If it doesn't meet either of those two criteria, you can use Step 4b instead.

3. Make non-Roth after-tax contributions

The next step is to actually make your non-Roth after-tax contributions. The specific mechanics of doing this vary by 401(k), so you'll have to ask your plan administrator or consult your **summary plan description** for the details.

The maximum contribution you can make is $54,000, minus your other employee and employer contributions. That means that you could theoretically contribute up to $36,000 per year after subtracting your $18,000 employee contribution. But for most people the maximum contribution will be lower, given that your employer will likely contribute money to your 401(k) as well.

As an example, let's say that you make $200,000 per year, contribute 9% of your salary to your 401(k) each paycheck, and that your employer fully matches your contribution up to 5% of your salary. That means that:

- You contribute the maximum $18,000 per year yourself.
- Your employer contributes another $10,000.
- Your allowed non-Roth after-tax contribution = $54,000 - $18,000 - $10,000 = $26,000.

In other words, in this example you would be allowed to contribute an additional $26,000 to your 401(k) as non-Roth after-tax money.

4a. Immediately roll over to a Roth IRA

In an ideal world, your 401(k) plan will both account for your non-Roth after-tax contributions in a separate sub-account AND allow for in-service withdrawals.

If that's the case, you can roll your after-tax contributions to a Roth IRA immediately after contributing them to your 401(k). Your contributions will not be taxed during the rollover. Your earnings will be taxed, but because you're doing it immediately those earnings will be minimal and therefore the tax hit will be minimal.

And once the rollover is done, all of that money AND the returns on that money will grow tax-free and be accessible tax-free in retirement.

Pretty cool, right?

Now, you need to be VERY clear that your 401(k) plan administrator understands exactly what you're trying to do here so that you avoid any unintended consequences. And the specific mechanics of doing this will differ by 401(k) provider and by the IRA provider you choose as well.

But in a nutshell, that's how it's done.

Quick note: I personally use Vanguard for my Roth IRAs, though there are plenty of great providers.

4b. Roll over to a Roth IRA after leaving your current company

If your 401(k) doesn't allow for in-service withdrawals, or if your non-Roth after-tax contributions aren't kept in a separate sub-account, you won't be able to do an immediate rollover.

What this means is that you'll likely have to wait until you leave your current employer before you can roll the after-tax money into a Roth IRA. And in the meantime, those after-tax contributions may build up significant earnings that will potentially be taxable when you do roll it over.

And while that's not ideal, there are two reasons why it's likely still worth taking advantage of this strategy:

1. When you do roll the money over, you're allowed to split the rollover so that all your pre-tax money goes to a Traditional IRA and all your after-tax money goes to a Roth IRA. This allows you to avoid a big immediate tax hit, keep your pre-tax money growing tax-deferred in a Traditional IRA, and still get significant money into a Roth IRA that will eventually be tax-free.

2. Harry Sit (The Finance Buff) ran the numbers on rolling the ENTIRE after-tax sub-account, including the earnings, to a Roth IRA vs. simply investing in a regular taxable investment account. He found that in most cases taking advantage of the Mega Backdoor Roth IRA was preferable to a taxable investment account, even if you had to wait a few years before rolling it over and you took the tax hit on the rollover. There are exceptions though, particularly if you plan on staying with your current employer for a long time.

All of which is the say that even if you can't immediately roll your after-tax contributions to a Roth IRA, there's still a good chance that the Mega Backdoor Roth IRA will come out ahead of investing in a taxable account (though still behind investing in other tax-advantaged accounts).

Again, the specifics of doing all of this depend heavily on your 401(k) and IRA providers, so you'll need to work closely with those people to make sure they understand exactly what you're trying to do.

Mega-size your retirement savings

So there it is, the Mega Backdoor Roth IRA. It's the hidden way to contribute tens of thousands of dollars to a Roth IRA every single year, no matter how much money you make.

If you have the money to contribute, and if your 401(k) is set up to allow it to happen, it's a pretty sweet deal.

Have you ever taken advantage of this strategy? Do you have any questions about it? Let me know in the comments below!

Want More Guidance?

I know how hard it can be to balance all the financial responsibilities that come with starting a family. From paying your bills, to saving for the future, to trying to enjoy yourself in the meantime, it's not easy figuring out what to prioritize and how to find room for everything.

As a fee-only CERTIFIED FINANCIAL PLANNER™ who specializes in working with new parents, I work every day with other parents who want to make the right financial decisions for their families. And as a dad with two young boys myself, my wife and I are going through many of the same things you are.

It's not easy. And that's why I offer a range of options for you to get more guidance.

If you'd like more help with your financial questions, here are a few different ways you can get it:

- The **Jump Start Session** allows us to work together to craft a personalized financial plan for your specific goals and situation. And it's pay-what-you-can so that you can get the advice you need at a price you can afford.
- If you're more of a DIYer, I offer a variety of **financial guides** designed to walk you step-by-step through the most important parts of your financial plan..
- Please feel free to email me any time with any questions that are on your mind. I'd love to hear from you and I'm always happy to help. My email address is matt@momanddadmoney.com.