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How Plan Sponsors Can Offer Backdoor Roth Conversions

Is a strategy that allows high-earners to roll over some of their retirement money into a Roth account worth the administrative burden for plan sponsors?

Reported by REMY SAMUELS

As Congress has increased "Rothification" of retirement investing with the SECURE 2.0 Act of 2022, many plan participants and plan sponsors have begun to consider a strategy known as a "backdoor Roth conversion."

However, this conversion can become quite complicated for plan sponsors who wish to implement it, as it requires several additional features to make the conversion possible.

Plan sponsors also need to be aware of the various tax implications and work closely with their recordkeepers to manage the administrative burden.

What Is a Backdoor Roth Conversion and How Does It Work?

First, it is important to understand a backdoor Roth conversion and why plan sponsors may want to offer this feature to participants.

Also known as a "mega backdoor Roth," the strategy allows people who would typically be ineligible to contribute to a Roth account, due to exceeding income or contribution limits, to transfer money from their 401(k)— or qualified employer-sponsored retirement account—into a Roth IRA and/or Roth 401(k).

This conversion is particularly advantageous for high-income earners who make too much to contribute to a Roth IRA directly, according to Fidelity Investments. Those who earn at least $153,000 as a single taxpayer or at least $228,000 as a married-filing-jointly taxpayer cannot contribute directly to a Roth IRA in the 2023 tax year.

Additionally, if an employee only makes pre-tax contributions, the most they can contribute to a retirement plan is $22,500 (or $30,000 if the participant is age 50 or older). But with after-tax contributions, participants can contribute up to $66,000 ($73,000 if 50 or older). Any amounts contributed by an employer count toward that limit.

"The real appeal with converting is to build more assets that are completely income tax-free upon withdrawal and are tax-free to their heirs upon withdrawal," says Kelli Send, senior vice president of participant services at the Francis Investment Council.

A participant who engages in this conversion, however, must pay income tax on their pre-tax contributions and on untaxed earnings derived from that money.

How Plan Sponsors Can Implement a Backdoor Roth Strategy

According to Deba Sahoo, the senior vice president and product area leader at Fidelity, plan sponsors must have a few other features in place before they can even think about offering a backdoor option.

In addition to offering Roth accounts, Sahoo says plan sponsors must allow after-tax contributions to their employer-sponsored retirement plan, as well as in-plan Roth conversions, in order for the backdoor conversion to be possible. Additionally, Sahoo says if the plan allows for in-service withdrawals or rollovers, the participant could roll over funds into an IRA.

Send says all plan sponsors will be required to offer a Roth account to employees starting in 2024 because of a new provision in the SECURE 2.0 Act of 2022. The legislation mandates that catch-up contributions to an employer's retirement plan be designated as after-tax Roth contributions.

Congress has leaned into Roth features because it means participants are paying income taxes when they earn their pay, as opposed to on a deferred basis, Send suggests.

When plan sponsors are first hiring a recordkeeper or moving to a new recordkeeper, Sahoo says it is important that they discuss the backdoor Roth option during conversations about plan features and design elements.

Sahoo also points out that plan sponsors need to make sure they are satisfying all compliance, auditing and administrative needs, as well as ensuring that they are educating and communicating with their employees about this backdoor option.

Potential Nondiscrimination Complications

Because the backdoor Roth option is mainly beneficial for high-income earners, and it requires plan sponsors to offer extra features, Sahoo says Fidelity sees a "very small percentage" of people taking advantage of this conversion option.

Sahoo estimates that between 0.03% to 0.04% of all eligible participants take advantage of the backdoor Roth conversion per year at Fidelity. He said this is somewhere between 5,000 to 10,000 people.

"I think for plan sponsors, the primary benefit [of the backdoor Roth] is attracting and retaining highly compensated talent," Sahoo says. "It's a way to save for retirement beyond what is normally available."

But Sahoo says it is essential that plan sponsors offer this feature to their entire population, not just the highly compensated, because they can run into nondiscrimination testing issues.

The IRS conducts these tests to ensure that plans are not overly utilized by highly compensated employees, and if they find that a retirement plan is only heavily used by these individuals, the plan could fail.

"It's important that plan sponsors think about nondiscrimination testing and make sure that they're offering these features to all eligible employees," Sahoo says.

Marcia Wagner, founder and managing partner of the Wagner Law Group, says IRS nondiscrimination rules might also limit the amount that high-income taxpayer could contribute to the after-tax contribution account in a tax-qualified plan. However, she said the only dollar limit on after-tax contributions to a defined contribution plan would be the Internal Revenue Code Section 415 limit, which is $66,000 in 2023.

"So, for example, if an individual established a solo 401(k) plan in 2023, he or she could contribute zero pre-tax dollars and $66,000 on an after-tax basis," Wagner said in an emailed statement. "He or she could then withdraw this amount and contribute it to a Roth IRA. Unlike pre-tax deferrals to a 401(k) plan, the [Internal Revenue] Code generally does not provide limitations on the timing of withdrawals of after-tax contributions. If a 401(k) plan also provided for in-plan Roth conversions, plan participants could also take advantage of that provision."

Recordkeeping Fees

While Sahoo says Fidelity does not charge a fee for these conversions, Send says other recordkeepers might charge a per-conversion fee and that plan sponsors and participants need to be aware of this before offering the feature.

Send says the backdoor Roth feature could be beneficial to early-career participants who may only have a few thousand dollars in a 401(k) account, because the money would compound completely tax-fee for the rest of their lives in a Roth. But if participants are forced to pay a recordkeeping fee, Send says that could render small conversions unadvisable.

For example, if a 25-year-old received $1,000 from their company in a match last year and wanted to convert that to a Roth account, they may get hit by a $150 fee from the recordkeeper. Send says she would not advise someone to pursue this conversion, because it takes a significant chunk out of their retirement savings.

Overall, Send says there is no reason for plan sponsors not to offer the backdoor feature, but it requires a lot of education and advice for participants.

At the same time, Wagner points out that backdoor Roth accounts are currently a "legitimate tax strategy" but have come under attack in recent years because they permit some ultra-wealthy taxpayers to accumulate extremely large amounts of money in their Roth IRA.

Provisions intended to eliminate the backdoor conversion were included in the proposed Build Back Better Act and are also included in President Joe Biden's budget. Prior to that, during the presidency of Donald Trump, a conference report accompanying the Tax Cut and Jobs Act acknowledged the backdoor Roth strategy was used to avoid the income limits on Roth IRA contributions.

However, Wagner said the only action taken at the time was to prohibit conversions to Roth IRAs from being recharacterized as traditional IRAs.

This threat prompted some financial professionals to suggest their clients make conversions before the end of 2021, but the Build Back Better Act proposal died in the Senate and never became law.

Tags Defined Contribution, Roth, Roth 401(k), Roth IRA, SECURE 2.0 Act of 2022

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