EGPS
A BLUE RIDGE COMPANY

BACKDOOR ROTH

An overview of the strategy, pros and cons

"Backdoor Roth"

A Roth IRA is a retirement savings account where contributions are not deductible when made, but are tax-free upon withdrawal, assuming some conditions are met. A Roth IRA also comes with an annual contribution limit. High-earners making over a certain amount are not eligible to contribute to a Roth IRA at all. Roth contributions to a 401(k) plan are also limited in amount, but not due to income. Enter scene: the "backdoor Roth" concept.

A "backdoor Roth" transaction occurs when after-tax employee contributions are made to a plan for the purpose of converting these dollars to Roth as soon as they enter the plan. This can be done either through an in-plan Roth rollover, plan permitting, or a rollover/conversion to a Roth IRA. Only earnings accrued between contribution and the conversion are taxed.

These after-tax contributions are not deferrals, and therefore are not subject to the 402(g) limits. This means the backdoor strategy provides the potential to put a large amount into the plan that will ultimately be treated as Roth dollars. The benefit of a backdoor Roth is that it allows those with higher incomes who can't contribute to a Roth IRA additional ability to take advantage of the Roth IRA benefits. In addition, although the after-tax contribution is included in the 415 annual additions limit, the plan participant has the potential to save a lot more in the plan than they could otherwise. There are also drawbacks of this strategy.

The downside

The "backdoor Roth" option is not effective for most plans due to the inclusion of after-tax contributions and matching contributions in ACP (actual contribution percentage) testing. The ACP test must be passed yearly to ensure highly compensated employees (HCEs) are not benefitting significantly more than non-highly compensated employees (NHCEs). Therefore, if only HCEs are taking advantage of this contribution option, and nonHCEs are either not getting a match, or only a small match, the plan will fail ACP testing. Then, the after-tax contribution must be refunded to the HCE. The ACP testing will apply even if the plan doesn't provide for a matching contribution, and even if the plan is safe harbor! This caveat makes the backdoor Roth option impossible for many plans.

Ideal candidates

A "backdoor Roth" option can work well for an owner only plan, or where only HCEs are in the plan, and the ACP test isn't an issue. This strategy allows increased plan contributions that are not subject to the employer deduction limit and for the money to be treated as Roth for future tax-fee growth on earnings.