Fidelity Benefits Consulting

Backdoor Roth

Combining After-tax Contributions with Roth Conversions to Optimize 401(k) Plans

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We have heard many plan sponsors ask how their participants can increase the amount of tax-advantaged dollars in their qualified plans. For individuals already deferring the maximum allowable amount to their traditional or Roth 401(k), combining additional after-tax contributions with a Roth conversion can be a great option. Plan sponsors should understand how the "backdoor Roth" works and decide if it makes sense for their plan.

What's Inside

- Understanding the basics
- Using Roth conversions to provide tax-free investment opportunities
- Key considerations to get started
- How does the Backdoor Roth Strategy work?

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Understanding the basics

Each year, employee elective deferrals to a 401(k) plan are limited to a dollar cap. In 2019, this cap is $19,000 (plus an additional $6,000 if age 50 and over). The cap applies to the combination of two types of deferrals:

2019 CAP is $19,000[1]

TYPE 1:
Traditional 401(k) deferrals

Contributions are made on a pre-tax basis, distributions upon retirement are taxed as ordinary income

TYPE 2:
Roth Deferrals

Contributions are made on a post-tax basis; however, distributions upon retirement are received tax-free[2]

** 2019 cap for participants 50 years of age and over is $25,000.*

Many employees who reach this $19,000 threshold would welcome the opportunity for additional tax efficient savings. While the IRS rules generally allow for after-tax contributions beyond the $19,000, investment returns on these after-tax contributions are tax deferred, but eventually taxed upon distribution as ordinary income.

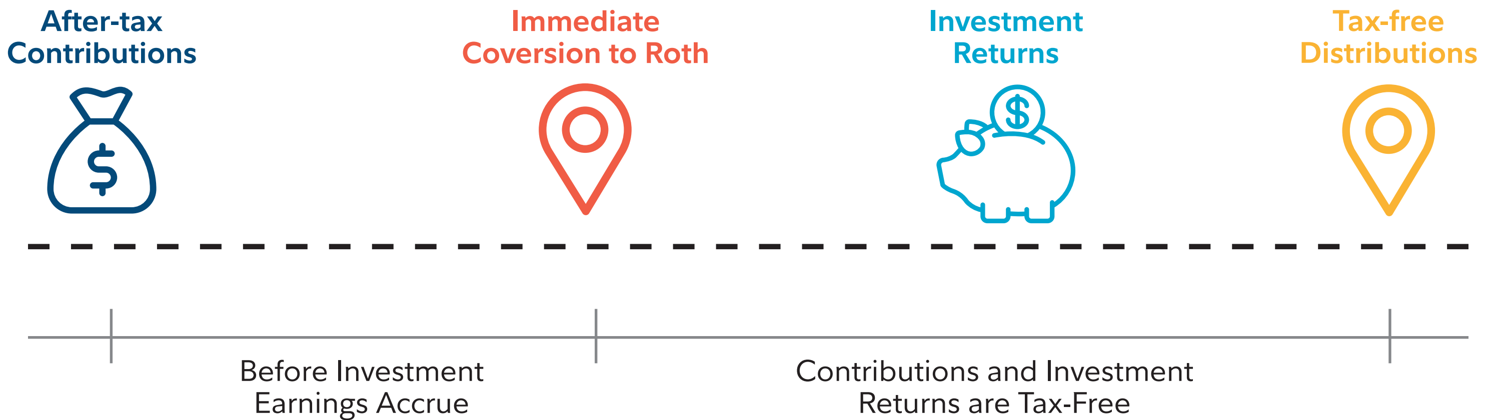
Some plans maintain a provision allowing for these after-tax contributions, but very few employees utilize this feature due to the taxation of investment earnings. If the tax on the investment return could be avoided by moving the funds to a Roth account, then the after-tax feature would be significantly more attractive.

Using Roth conversions to provide tax-free investment opportunities

Conversion of traditional 401(k) balances is comparable to the conversion of traditional IRAs to Roth IRAs. Participants make an election to convert their balance, pay any income tax due at the point of conversion, and the balance is treated as Roth money going forward. This means that, from the point of conversion, any investment return earned is tax-free at the time of distribution.

If a traditional 401(k) balance is converted, the full amount of the conversion is taxable in the year of conversion as taxes have never been paid on this money. If an after-tax 401(k) balance is converted, only the accumulated investment return on that account is taxable since taxes had already been paid on the contributions.[3]

In a strategy commonly referred to as “backdoor Roth”, after-tax contributions are made to the plan, followed immediately by conversion to Roth. By converting immediately, before investment earnings have accrued, the participant can avoid any immediate tax consequence. Additionally, all future investment returns would be tax-free on this source. The combination of contributing after-tax dollars and immediately converting to Roth has the same effect as if the participant had made a Roth contribution to begin with; however, the amount is not capped by the same limit of $19,000 – therefore allowing for additional tax-advantaged savings.



Here is how a participant can take advantage of the after-tax savings option.

Example: What backdoor Roth could mean for participants

While the $19,000 deferral limit is the most well-known 401(k) limitation, the IRS code section 415 limit sets the limit on total contributions to the plan. In 2019, the limit is $56,000 on the combination of employee traditional deferrals, Roth contributions, employer contributions and employee after-tax contributions. Let’s look at an example participant.

Meet Barbara

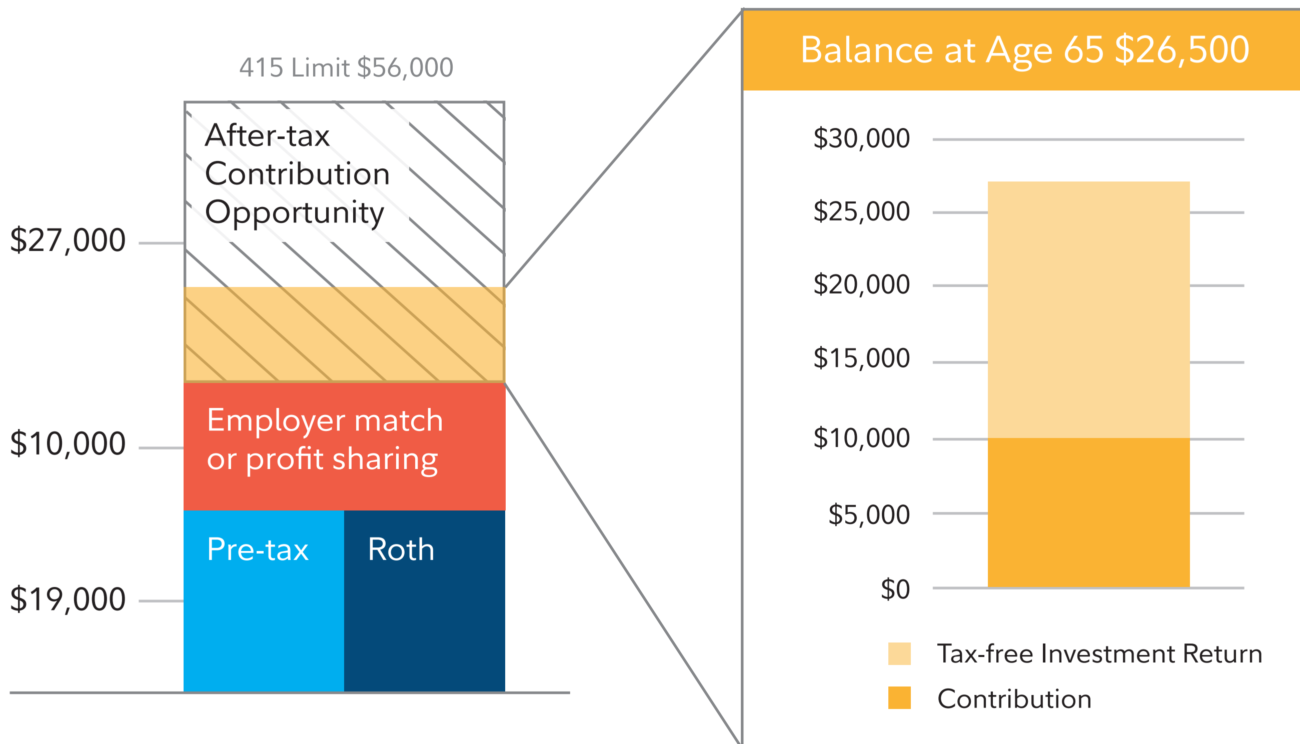
Age: 45
Salary: $200,000

Deferral election: 10% Roth
Plan match: 100% on the first 5% of deferral

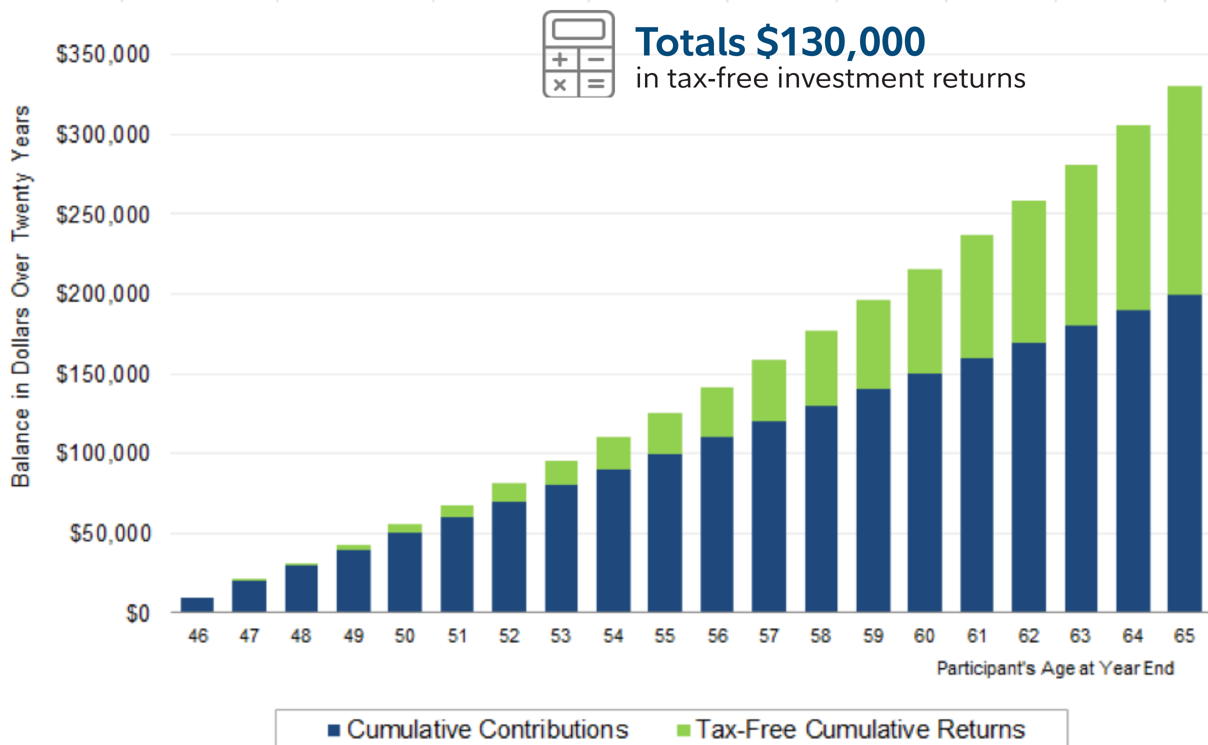
Barbara decides to take advantage of the after-tax contribution opportunity and contribute an additional $10,000 converting immediately to Roth. Assuming a 5% return, this $10,000 contribution will generate $16,500 in investment return by age 65. By converting to Roth, and assuming a 25% tax rate, Barbara saves over $4,000 in taxes using this strategy.

- A 10% election results in this participant hitting the $19,000 limit.
- Since this participant is not yet 50, they are not eligible for catch up contributions.
- The 5% match is $10,000.
- Therefore, there is an additional $27,000 of room for after-tax contributions.

This illustration looks only at limitations due to the 415 limit. Plan sponsors will also need to consider the impact on nondiscrimination testing.



If Barbara continues to contribute $10,000 each year for twenty years, she can earn $130,000 in tax-free investment returns (assuming a 5% annual return). This represents a $32,000 tax savings, assuming a 25% marginal tax rate at retirement.



Key considerations to get started

Here are a few things for plan sponsors to consider when providing this opportunity to their 401(k) plan participants:

1

REVIEW THE PLAN PROVISIONS
The plan will need to allow for after-tax contributions and have a provision permitting Roth conversions.

2

UNDERSTAND TAX IMPLICATIONS
If a plan participant *already has an* after-tax balance, the initial conversion to Roth may have tax implications for participants.

3

MODEL POSSIBLE IMPACT TO NON-DISCRIMINATION TESTING
After-tax contributions will impact the nondiscrimination testing of the plan even if the plan qualifies as a safe harbor. Evaluate adding a cap on after-tax contributions if testing requirements are an issue. Testing issues can also be managed through refunds to maximize savings opportunities.

4

COMMUNICATION IS KEY!
For this program to be successful, your plan participants will need to clearly understand the value of this strategy and the mechanics for executing it.

For more information

As with many 401(k) plan design strategies, the key to success is working through the specific regulatory, administrative, and communication challenges. For more information on how to determine if this strategy is right for your plan and your participants, please contact your Fidelity relationship manager, or email the Fidelity Benefits Consulting group at fidelitybenefitsconsulting@fmr.com.

[1]The IRS Code Section 402(g) limit in 2019.

[2]A distribution from a Roth 401(k) is federally tax free and penalty free, provided the five-year aging requirement has been satisfied and one of the following conditions is met: age 59½, disability, or death.

[3]Plan sponsors should confirm after tax contributions are being tracked as a separate source.

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