Volume 30, Issue 1, March 2024

# Commco Comments

Timely Information and Updates for Employers and Retirement Plan Sponsors

## Could A Mega Backdoor Roth Strategy Work Within Your Plan?

If you or your employees are looking for ways to boost retirement savings beyond ordinary limits, you may have heard of the “mega backdoor Roth” strategy. This is a method of making after-tax contributions to a 401(k) plan and then converting them to Roth, either within the plan or in an IRA. This strategy is not for everyone. It depends on several factors, such as income level, plan design, and tax situation. Here are some questions a participant should review before considering the mega backdoor Roth:

**Are you a highly compensated employee (HCE) who is already maximizing your Roth 401(k) contributions?** If so, you may benefit from making additional after-tax contributions and converting them to Roth, as this will allow you to save more money in a tax-advantaged account. However, if you are not using the Roth 401(k) option, you may want to start there first, as it has lower contribution limits and simpler rules than the after-tax option.

**Are there non-highly compensated employees (NHCEs) in your plan?** If so, you may face some challenges with the after-tax option, as it is subject to nondiscrimination testing. This means that the average contribution rate of the HCEs cannot exceed the average contribution rate of the NHCEs by more than a certain amount (usually 2%, but varies depending on NCHE contributions). If you are an HCE who has made after-tax contributions and your plan fails this test, you may be forced to withdraw some or all of those contributions and pay taxes and penalties on the withdrawal.

**Is your plan a Safe Harbor plan?** If so, you may think that you are exempt from nondiscrimination testing, as Safe Harbor plans typically satisfy these requirements by providing a minimum level of employer contributions to all eligible employees. However, this only applies to pre-tax and Roth 401(k) contributions, not to after-tax contributions. Therefore, even if your plan is a Safe Harbor plan, you still have to pass the nondiscrimination test for the after-tax option.

**Is your plan a solo plan, a plan with only HCEs, or a very large plan that can use the top-paid group election?** If so, you may have an easier time with the after-tax option, as these types of plans are more likely to pass the nondiscrimination test (or avoid it altogether). A solo plan is a plan that covers only one individual or one individual and their spouse. A plan with only HCEs is a plan that does not have any NHCEs participating. A very large plan is a plan that has more than 2,500 participants and can elect to limit the nondiscrimination testing to the top 20% of employees based on compensation.

**Advantages of the mega backdoor Roth strategy (if allowed by your plan):**

- Employees can make after-tax contributions to boost their total plan additions up to the annual limit, which is $69,000 in 2024 ($76,500 for those 50 or older). This is much higher than the limit for pre-tax and Roth 401(k) contributions, which is $23,000 in 2024 ($30,500 for those 50 or older).

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*A plan with more than how many participants may be able to limit its nondiscrimination testing to 20% of employees?*

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- Participants can roll over after-tax contributions to a Roth IRA without paying any taxes or penalties. This will provide more flexibility and control over investments and withdrawals in retirement.
- If your plan allows it, after-tax contributions can be converted to Roth within the plan. This is called an in-plan Roth rollover, and it has the same tax effect as rolling over to a Roth IRA. However, it may be simpler and faster than doing an external rollover.

**Disadvantages of the mega backdoor Roth strategy:**

- Employees may have to pay taxes on the earnings of after-tax contributions when converting them to Roth. This is because only the contributions are considered after-tax, not the earnings. Therefore, if the after-tax account has grown in value since contributions were made, taxes will be owed on the difference between the amount contributed and the amount converted.
- The tax reporting and recordkeeping requirements for this strategy are complex. This is because the account owner must track the basis (the amount of after-tax contributions) and the earnings of their after-tax account separately from their pre-tax and Roth accounts. The account owner must also report any rollovers or conversions of after-tax accounts on IRS Forms 1099-R and 8606.
- Participants may face additional fees or restrictions from the plan provider or custodian. Not all plans offer the after-tax option or allow rollovers or conversions of after-tax funds. Those that do may charge extra fees or impose limits on the amount or frequency of these transactions.

As you can see, the mega backdoor Roth strategy is a powerful but complex way to increase retirement savings. Anyone considering this potential strategy should consult with a plan administrator, a tax professional, and a financial advisor before beginning, as it may not be suitable within all employer plans or for all individual situations.