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Build Back Better Act Threatens Backdoor Roth Conversions

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The Build Back Better Act, the “social infrastructure” bill that was approved by the House of Representatives on November 19, 2021, includes new restrictions on so-called “backdoor Roth” conversions. Accordingly, if the Senate approves the Build Back Better Act, it will likely end this strategy for generating additional tax-advantaged savings for after-tax contributions.

Backdoor Roth Conversions

Roth contributions are after-tax contributions to an individual retirement account (IRA) or 401(k) Plan that can be withdrawn with related earnings on a tax-free basis in qualifying distributions after attaining age 59-1/2 or after death or disability. The tax code limits the ability of individuals to make IRA contributions on a Roth basis based on their income level. However, 401(k) plans can permit employees to make Roth contributions up to the 401(k) contribution limits (\$19,500 for 2021) regardless of the employee’s income level. Further, employees may be eligible to convert any non-Roth contributions to Roth contributions either upon taking a distribution from the plan or under an in-plan rollover feature. With a Roth conversion, employees are taxed at the time of the conversion on any before-tax amounts that are converted to a Roth (after-tax) basis.

A “back-door Roth” conversion is a strategy that can allow employees to generate Roth contributions above what would be possible under the 401(k) contribution limits. Some 401(k) plans allow employees to make voluntary after-tax contributions on a non-Roth basis. Non-Roth voluntary after-tax contributions are not as tax-advantaged as Roth contributions because, although the after-tax contributions themselves are not taxed again upon distribution, the earnings on these contributions are taxable upon distribution.

However, in a back-door Roth conversion an employee can avoid any taxation of earnings on after-tax contributions by immediately converting voluntary after-tax contributions to Roth contributions before earnings are generated. This effectively allows the employee to generate Roth contributions in excess of the 401(k) contribution limits because voluntary after-tax contributions are not subject to the same contribution limits as Roth contributions.

Build Back Better Act Changes to Roth Conversions

The Build Back Better Act would put an end to these backdoor Roth conversions by prohibiting voluntary after-tax (non-Roth) contributions from being converted to Roth after-tax contributions effective December 31, 2021.

The Build Back Better Act would also prohibit taxpayers from executing similar backdoor Roth conversions outside of the 401(k) context by rolling over after-tax amounts in traditional IRAs to Roth IRAs.

Of course, Senate approval of the Build Back Better Act is far from certain, but its passage by the House with these provisions makes it much more likely that if the legislation is ultimately enacted it would result in a sudden end to backdoor Roth conversions.