White Paper

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The Roth 401(k) and Roth IRA: Comparing Roth Accounts for Retirement Savings

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The Roth savings vehicles, the Roth IRA and Roth 401(k), are often misunderstood in the world of financial instruments used in retirement savings. Although they are very similar in their tax treatment, especially with respect to distributions, they are quite different in their actual application. Within this article, I'll attempt to compare the two for greater understanding.

One must realize, that unless you are self-employed, you would be unable to open a Roth 401(k) as it is a part of a retirement plan that is offered by the employer; however, the Roth IRA also has rules surrounding it's use and is not available to everyone.

Let's dive into this fascinating and confusing world, beginning with a comparison of contributions allowed under each plan.

Contributions – Roth 401(k) vs. Roth IRA

Here's a comparison of the maximum contributions for both plans:

- The Roth 401(k) maximum is set by §402(g) of the Internal Revenue Code (IRC) and is subject to annual indexing for inflation. For 2022, the limit for contributions annually is $20,500. This is also the same limit that applies to the traditional or "pre-tax" 401(k) contributions. This limit is applied in aggregate to the total of the employee's traditional 401(k) contributions and Roth 401(k) contributions.

In both cases, these limits for an individual are added as a total for each type of contribution. In other words, if a person has both a Roth 401(k) and a traditional 401(k), the maximum contribution annually combined is still $20,500. Likewise, contributions for multiple Roth IRAs combined for an individual may not exceed the annual limit of $6,000 within a calendar year.

- The Roth IRA maximum annual contribution is set by IRC §219(b)(5)(A) and is also subject to annual indexing but calculated somewhat differently. For 2022, the limit is $6,000.

However, for contributors 50 years of age and older, the Economic Growth and Tax Relief Reconciliation Act of 2001 created an exception to the above maximum limits. Older workers can take advantage of this “catch-up” provision to contribute additional funds for retirement. Anyone turning 50 in a calendar year, from January 1st to December 31st, regardless of birthday, is eligible to take advantage of this limit increase.

In 2002, a mere $1,000 was the limit for additional catch-up contributions for a 401(k). By 2022, to keep up with cost of living increases, the limit has been increased to $6,500.

IRA additional contributions for older workers are limited to $1,000 and, unlike their counterpart within a 401(k) plan, they are not indexed for inflation.

In total, for those aged 50 and older, the combined contribution limit for a Roth 401(k) for 2022 is $27,000 while the Roth IRA limit is $7,000.

Who can contribute?

In our comparison of the two Roth accounts, the most disparity relates to the Roth IRA being an account type while a Roth 401(k) is a simple tax treatment of contributions within an employee’s retirement plan.

Anyone can “have” a Roth IRA, but the key is who can contribute to a Roth IRA in a particular year. There are two limits based on filing status of the account owner’s tax return for that year.

- **Married joint or qualified widower**

  The account owner must have Modified Adjusted Gross Income (MAGI) of less than or equal to $204,000 for a full contribution. The contribution amount is phased out for MAGI at $214,000

- **Single, head of household or married filing separately (and did not live with spouse)**

  The account owner must have MAGI of less than or equal to $129,000 for a full contribution and the contribution is phased out for MAGI at $144,000. For married taxpayers filing separately, the contribution is phased out for income under $10,000 and is eliminated at MAGI of $10,000.

The table on the next page summarizes

Married Joint or Qualifed Widower	Single, Head of Household or Separated	Married Separately	Base Contribution	Catch-up Contribution
<= 204,000	<= 129,000	0	6,000	1,000
205,000	130,500	1,000	5,400	900
206,000	132,000	2,000	4,800	800
207,000	133,500	3,000	4,200	700
208,000	135,000	4,000	3,600	600
209,000	136,500	5,000	3,000	500
210,000	138,000	6,000	2,400	400
211,000	139,500	7,000	1,800	300
212,000	141,000	8,000	1,200	200
213,000	142,500	9,000	600	100
214,000 +	144,000 +	10,000	0	0

For the Roth 401(k), a participant needs only to participate in a plan that allows these contributions. All plans that allow Roth 401(k) contributions will also allow traditional contributions so the participant will need to determine contribution amount for each type. There are no limits or phase outs associated with the Roth 401 (k) beyond the 402(g) limit and catch-up limit discussed above.

Where the "magic" is - distributions

Anyone considering a Roth account should know that although the tax treatment going in differs, the real magic occurs when money comes out of the account. If the funds meet the IRS's two requirements, the entire distribution is completely tax free.

The first of the two requirements is that the distribution must be deemed "qualified." This is accomplished if the account owner has achieved one of three (or four for Roth IRA) triggers: attain age 59 ½, die or become disabled. Roth IRAs add first-time homebuyer (up to $10,000 lifetime maximum) to this list.

The second requirement is that the initial IRA contribution must have been in the account for five years. In calculating this time period, a contribution is considered to be made on the first day of the tax year. For example, if a contribution was made in November 2021, the five-year period began January 1st, 2021. For contributions made in February of 2022, the five-year period would begin January 1st, 2022. There is a similar rule for funds converted from a traditional account to a Roth. For inherited Roth accounts, there is also a five-year clock.

Distributions that are taken and do not meet the qualifications above are subject to a 10% penalty on part of the distribution. I say part because in making the contribution to either type of Roth, there has been no tax benefit. In other words, the contribution represents "tax basis" within the account. The full impact of this penalty depends on which type of account an individual has and the amount of the distribution.

- For a Roth IRA, the tax rules stipulate that contributions, and therefore basis, come out of the account first. There is no tax or penalty if the distribution amount is equal to or less than the basis in the account.

- For a Roth 401(k), distributions would be subject to the terms of the plan. Qualified plans are usually specific and do not allow ad hoc or on-demand distributions. A distribution from a qualified plan does not have the ordering rules that Roth IRAs do. Instead, the law considers the distribution to be a pro-rate distribution of Roth and non-Roth funds. Therefore, some of the funds are taxable and some are not. A penalty could be imposed, in addition, based on the terms of distribution.

Roth 401(k) balances reside within larger qualified plans. Therefore, basic requirements still apply. At age 72, Roth 401(k) owners are subject to Required Minimum Distribution (RMD) rules.

Conversely, Roth IRA balances do not have any minimum distribution requirements. Distribution transactions don't generate tax revenue, so there's no reason for the government to require balances to be distributed.

For retired employees holding Roth funds with a 401(k) balance, the RMD rules are a good reason to consider a rollover from a 401(k) to a Roth IRA.

Features of the Roth 401(k) and Roth IRA plans

Bankruptcy protections

Federal bankruptcy laws provide different treatments for balances in IRAs and funds that are held in a qualified retirement plan subject to the Employee Retirement Income Security Act of 1974 (ERISA). This gives a distinct advantage to qualified plans like a Roth 401(k), where the protections of ERISA apply. The anti-alienation provisions of ERISA are deemed to supersede the bankruptcy code and all balances within a Roth 401(k) are protected without limit.

Meanwhile, an individual's balances across ALL IRA accounts are consolidated and protected up to $1,362,800. Any balances above this amount are subject to the bankruptcy proceedings and will likely be used to satisfy creditors.

Loans

Many 401(k) retirement plans allow for participant loans. However, this can differ between employer plans and the specific provisions of the loan policy need to be consulted.

IRA rules prohibit loans, and therefore are unavailable for Roth IRA owners.

Matching contributions

For Roth 401(k) contributions, plans often do provide for an employer match and would provide a matching contribution to all 401(k) contributions combined. The plan would have a prescribed formula for computing this match and it may be limited such that not all of the contribution would match. The plan's Summary Plan Description (SPD) should be consulted to confirm the matching provisions.

There is no provision for any form of matching contributions with a Roth IRA.

Rollovers

The ability to receive a rollover or conversion is dependent on the terms the employer has established within their 401(k) plan. The plan could allow for rollovers of the Roth portion from a separate 401(k) or 403(b). In addition, balances that a participant had in the Roth 401(k) could be rolled over to a Roth IRA or the Roth portion of a 401(k) or 403(b). The Summary Plan Description would need to be consulted to determine each plan's specific capability.

IRAs have the most flexible rollover provisions in that they can receive rollovers of Roth funds from any other Roth IRA as well as the Roth portion of any 401(k), 403(b) or 457(b) employer sponsored plan. Further, the traditional or taxable portion (non-Roth portion) of any 401(k), 403(b), 457(b) or traditional IRA can be converted to a Roth IRA through a taxable conversion. This taxable conversion, as the name implies, is subject to tax for the tax year the conversion occurs.

Investment choices

In the case of the Roth 401(k) the investments are determined based on the offerings that the employer and plan recordkeeper make available to plan participants. Generally, this is limited to a strict menu of offerings; however, some plans provide for a brokerage window that allows participants to invest in a virtually unlimited number of options.

For Roth IRAs, the investment choices can be virtually unlimited. Generally, the limitation is based on constraints of the service provider. The law does prohibit the use of some investments such as collectables or those with some conflict of interest.

Planning Idea - possibly with a limited window

As noted above, the Roth IRA has limitations on who can contribute that are tied to earnings and filing status of the taxpayer; however, there is a legal way to get around these limits. The Backdoor Roth, frequently under attack by lawmakers could allow higher income individuals access to this retirement savings tool.

There is a two-step process for implementing a Backdoor Roth IRA:

1. **Making a legal contribution to an IRA**

   Most taxpayers realize that, like the Roth IRA, contributions to traditional IRAs are also limited; however, the limitation isn't implemented by disallowing contributions, as they are in the case of the Roth. Instead, they are limited in their ability to be deducted from income.

   As such, anyone, regardless of income, can make a traditional IRA contribution. The deductibility of this contribution might be limited based on the income reported on their tax return or whether their employer offered a retirement plan. To the extent that a contribution is made to an IRA that isn't deductible. The taxpayer has "basis" in the IRA. This "basis" is simply an amount or portion that can be distributed without taxes applied in the future. Regardless of the deductibility question, there is an absolute limit of $6,000 each year ($7,000 if you are age 50 or older). So, the first step is to make a non-deductible contribution to a traditional IRA.

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2. **Traditional IRAs can be converted to a Roth IRA**

   In doing so, the taxpayer would pay taxes on this conversion in the current tax year. In this case, where there is "basis" in the IRA, this amount is netted from the balance being converted in determining the amount of the IRA subject to tax. In the case of the backdoor Roth IRA, the conversion process begins very shortly after the initial contribution to the traditional IRA and since none of it was deductible, the entire conversion is considered "basis" and no tax is due. Therefore, the second step is opening a Roth IRA and converting the balance from the traditional IRA.

Reviewing this two-step process, we see that no deduction was received on the initial contribution and, at the end of the process, the balance is held in a Roth IRA. This essentially provides a way to bypass the contribution rules for Roth IRAs.

Closing comment

With massive amounts of turnover in the U.S. job market recently, many workers have been faced with decisions about what to do with 401(k) accounts from previous employers. Whether you are looking to roll-over an account, supplement existing retirement accounts, or just beginning the process of saving for retirement, a Roth 401(k) or Roth IRA might be attractive options.

Through the overview and comparison, it's easy to see how one might become confused on the topic of Roth accounts, their availability and the rules surrounding them. I'm hopeful that by highlighting these issues I've aided the reader's understanding and possibly provided ideas for their own consideration.

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