7 Key Differences Between a Roth 401(k) and a Roth IRA

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– Denise Appleby, APA, CISP, CRC, CRPS, CRSP

Roth 401(k)s and Roth IRAs share the ultimate goal of tax-free distributions of earnings, but they are governed by different rules along the way. This side-by-side comparison can help determine which vehicle suits your needs best.

Roth 401(k)s and Roth IRAs share the ultimate goal of tax-free distributions of earnings. But while both of these accounts are funded with amounts that have already been taxed, the path to that tax-free goal is paved with different rules for each of these two types of accounts.

As you consider your retirement planning needs, which will likely include adding Roth options for a tax-diversified retirement nest egg, the following overview of the differences might be helpful with determining which Roth account is more suitable.

Note: A designated Roth contribution can be made to a designated Roth account under a 401(k), 403(b), thrift savings plan (TSP), or for a 457(b) plan; contributions are usually labeled by the type of plan to which they are made. For instance, if a designated Roth contribution is made to a 401(k) plan, the account to which the contribution is made is called a Roth 401(k) account. For purposes of this article, Roth 401(k)s, Roth 403(b)s, Roth TSPs, and Roth 457(b) accounts will be referred to collectively as Roth 401(k)s unless otherwise stated.

1. Contribution limit

The contribution limit for a Roth 401(k) is higher than the contribution limit for a Roth IRA.

Roth 401(k)

For calendar year 2023, a participant may make elective contributions of 100% of compensation up to $22,500 to a Roth 401(k). A participant who is at least age 50 by the end of the year may make an additional catch-up contribution of $7,500.

These contributions apply on a per individual basis, and are aggregated with contributions to traditional 401(k) plans. As a result, the limit of $22,500 plus $7,500 catch-up can be contributed to one Roth 401(k); or split among more than one Roth 401(k) and traditional 401(k)s, Roth and traditional 403(b)s, and Roth and traditional thrift savings plans. Contributions to 457(b) plans are not included in this aggregation, which means that an individual can still make contributions of $22,500 plus catch-up contribution of $7,500 to 457(b) plans, even if he makes elective contributions of up to that amount to a Roth 401(k) or other account.

Roth IRA

The contribution limit for a Roth IRA is 100% compensation up to $6,500; with a catch-up contribution of $1,000 for those who are at least age 50 by the end of the year. Roth IRA contributions are aggregated with contributions to traditional IRAs. This means that an individual's total regular contribution to both a traditional and a Roth IRA must not exceed $6,500 for the year, plus an additional catch-up contribution of $1,000.

Contributing to both

Contributions to a Roth 401(k) and the Roth IRA do not affect each other. Therefore, an individual can make the maximum contribution amount to both accounts if eligible.

Example: John, who is 42, works for a construction company from which he receives $50,000 in W-2 wages for the year. John also does some consulting on the side for which his income is $30,000 for the year. John can make a Roth elective deferral contribution of $22,500 to the construction company's 401(k) plan, and still make a contribution of $6,500 to his Roth IRA.

2. Income limits

Roth 401(k) contributions are not subject to any income limits.

On the other hand, an individual is eligible to make a contribution to a Roth IRA only if that individual's modified adjusted gross income (MAGI) is below certain amounts. This MAGI is based on the individual's tax filing status. The following table shows the MAGI limits.

MAGI Limits

Tax filing status	2023 MAGI	Allowed contribution
Single	$138,000 or less	100%
	$138,000-$153,000	Partial
	$153,000 or more	None
Married filing jointly	$218,000 or less	100%
	$218,000-$228,000	Partial
	$228,000 or more	None
Married filing separately	Less than $10,000	Partial
	$10,000 or more	None

Source: Retirement Dictionary

For individuals whose MAGI falls within the phase-out range, calculations must be done to determine the amount of contribution for which they are eligible.

3. Availability

Access to a Roth 401(k) is dependent upon availability through an employer. An individual may not establish a Roth 401(k) plan independently, and must instead rely on an employer to provide access to such an account. Employers that want to offer Roth 401(k) accounts must first establish a traditional 401(k) plan and add the Roth 401(k) feature to the plan.

Anyone can establish a Roth IRA; and regular Roth IRA contributions can be made to the account as long as the individual's MAGI does not exceed the limits above.

4. Required minimum distribution

Roth 401(k) accounts are subject to the same required minimum distribution (RMD) rules that apply to traditional 401(k) accounts. Therefore, the account owner must start taking RMDs from her Roth 401(k) for the year in which she reaches age 73 and continue for every year thereafter. If the plan allows, RMDs can be deferred past age 73 until retirement.

Roth 401(k) beneficiaries are also subject to RMD rules.

Roth IRA owners are not subject to RMD rules.

Roth IRA beneficiaries are subject to RMD rules. An exception applies to spouse beneficiaries who transfer the inherited assets to their own Roth IRAs.

Tip on avoiding Roth 401(k) RMDs: An individual who does not want to take RMDs from a Roth 401(k), may rollover those assets to a Roth IRA, since Roth IRA owners are not subject to the RMD rules. If any RMD is due for the year in which the rollover occurs, that RMD must be taken before the rollover.

5. Qualified distribution definition and the 5-year rule

Qualified distributions from a Roth 401(k) or a Roth IRA are tax-free and penalty-free. Non-qualified distributions may be subject to income taxes, and a 10% early distribution penalty on any taxable amount. The 10% early distribution penalty does not apply if the distribution occurs on or after the date on which the account owner reaches age 59½, or if an exception to the penalty applies.

Qualified distribution definition

A distribution from a Roth 401(k) is qualified if it meets the following two requirements:

1. the individual has had the Roth 401(k) for at least five years, and
2. is either;
    - age 59½ at the time the distribution is made,
    - disabled,
    - deceased, in which case the distribution would be taken by a beneficiary.

Roth IRA distributions must also meet these requirements in order to be qualified, but there are two different distinctions.

- The five-year rule for a Roth IRA is determined on an aggregate basis, whereas the five-year period for Roth 401(k)s is determined on a per employer plan basis (see below).
- For the second option, a distribution from a Roth IRA is also considered qualified if the five-year period has been met and the distribution is taken for first-time homebuyer purposes. This is subject to a lifetime limit of $10,000.

6. Defining the 5-year period for a qualified distribution

When determining whether or not the five-year period has been met, each of an individual's Roth 401(k) accounts must independently meet this requirement. An exception applies when two Roth 401(k) accounts under different employer plans are combined. Under this exception, if one Roth 401(k) is moved to another using the direct rollover method, then the five-year period starts with the Roth 401(k) that was first established and funded. On the other hand, if the movement is done using the indirect rollover method, the five-year period starts when the receiving Roth 401(k) was established and funded.

For Roth IRAs, this five-year period starts with the individual's first Roth IRA. This is because all of an individual's Roth IRAs are aggregated for this purpose.

7. Recharacterization option

Recharacterization occurs when a contribution is changed from a traditional to a Roth or vice versa. A recharacterization must be done by the individual's tax filing due date plus extension, and must include any net income attributable to the transaction being recharacterized.

Once an individual makes an election to treat an elective contribution as a Roth 401(k) contribution, that election is irrevocable. As such, contributions to a Roth 401(k) may not be recharacterized.

A contribution to a Roth IRA can be recharacterized to a traditional IRA contribution, and vice versa.

Awareness of the differences can help with choice

While you can potentially make contributions to both of these types of accounts in some cases, an awareness of these differences—and of course any similarities—can help to ensure that you choose the account with the features that is more suitable. Awareness can also help to prevent you from choosing an account for which you might be ineligible. For example, if your tax filing status is single, you should not make a contribution to a Roth IRA if your MAGI is $153,000 or more (see table above).

Of course, consideration should also be given to whether a traditional account might be more suitable for you than a Roth account. In order to make this determination, a Roth versus traditional analysis should be done by your financial professonal.

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