ROTH IRA vs. ROTH 401k

There are various account types available to retirement savers. As part of the Tax Relief Act of 1997, the ROTH IRA was the first-of-its-kind retirement account type that offered qualified tax-free withdrawals. Later, the ROTH 401k was spawned from the Economic Growth and Tax Relief Reconciliation Act of 2001 and first made available in 2006. The ROTH 401k is an employer sponsored retirement plan that offers many of the characteristics of the ROTH IRA but also comes with some important differences. This article will lay out the basic similarities and differences between a ROTH IRA and a ROTH 401k.

The ROTH IRA is individually funded and while the ROTH 401k is an employer sponsored plan. Both account types are made with after-tax or post-tax contributions, but later, qualified distributions1 of principal and earnings are not taxable.

For tax year 2019, ROTH IRA contributions are limited to $6,000 per eligible person per year or $7,000 if the ROTH IRA owners is age 50 or better. There are many permissible investment options within a ROTH IRA such as mutual funds, stocks, bonds, certificate of deposits (CDs), money market, and exchange traded funds (ETFs). The rate of return earned on a ROTH IRA ultimately depends on the underlying investment(s) within the account. When taking withdrawals from a ROTH IRA, principal contributions (contributions you made) are considered withdrawn first, then earnings. To qualify to fund a ROTH IRA, you must have income below a certain threshold which is dependent on tax-filing status.

Unlike ROTH IRAs, ROTH 401ks do not have income limits for eligibility to make contributions. ROTH 401ks have a contribution limit which is much higher than ROTH IRAs. For tax year 2019, ROTH 401k contribution limits are $19,000 per person per year, or $25,000 if the account holder is age 50 or better. ROTH 401k generally limit investment options to a menu of pre-selected mutual funds. In taking withdrawals from a ROTH 401ks, principal and earnings are considered distributed on a pro-rata basis which may be less advantageous in the event a non-qualified withdrawal is taken.

There are several considerations in determining what type of ROTH to fund. Since a ROTH 401k is offered and sponsored by an employer, consider if your employer makes matching contributions to your ROTH 401k contributions. Some employers do not sponsor a ROTH 401k so a ROTH IRA may be your only option. Another important difference is that ROTH IRAs do not have required minimum distributions when the account holder turns age 70 ½, unlike the ROTH 401k.

It is this author’s belief that the evolution and increased availability of retirement savings options is increasing evidence that our legislators want to encourage saving for your own retirement verses relying on the government for retirement income (social security). Both the ROTH IRA and ROTH 401k can be attractive options in saving for retirement but weather one is “better” than the other is highly case specific.

*Adam Smit is CERTIFIED FINANCIAL PLANNER™ with Adam Smit Investment Management LLC and a registered principal of LPL Financial. Adam Smit Investment management LLC and LPL Financial do not provide tax or legal advice. The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine what investment(s) may be appropriate for you, consult your financial advisor prior to investing. Securities offered through LPL Financial. Member FINRA/SIPC.*

1. *Qualified distributions from ROTH IRA and ROTH 401k accounts are tax and penalty-free if you are at least age 59 ½ and ROTH contributions meet the IRS’s 5-taxable-years of participation test. For non-qualified distributions from ROTH IRA and ROTH 401k accounts, earnings are taxable and may be subject to a 10% early withdrawal penalty.*