An End to the Confusion! Roth 403(b)/401(k) vs. Roth IRA

Spring 2018
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Note: In this article the term Roth 403(b) is synonymous with Roth 401(k); the same rules apply.

People often confuse the features of and rules surrounding Roth IRA and Roth 403(b) contributions. In some ways these accounts are very similar: they both offer after-tax contributions and earnings may be withdrawn tax-free if certain requirements are met. Yet in other ways they are very different. In this article, we will stop the Roth confusion and explain the major differences between the two Roth accounts.

Income Ceiling. The most common misconception: "I earn too much to contribute to any kind of a Roth account." While that may be true for a Roth IRA, it is not true for a Roth 403(b). Roth IRA contributions phase out for individuals between income[1] of $120,000 and $135,000 and $189,000 and $199,000 for those married and filing jointly. *However, your income level is not a consideration in terms of your ability to make Roth 403b contributions.*

Contributions. Another benefit to Roth 403(b) accounts is that contributions have a higher ceiling. Roth IRA contributions are capped at $5,500 per person ($6,500 if 50 and older) whereas Roth 403(b) contributions are capped at $18,500 ($24,500 if 50 and older). A special note: matching contributions made by your employer are made in a pre-tax manner and therefore are not considered to be Roth contributions.

Distributions. Earnings may be withdrawn from a Roth 403(b) on a tax-free basis if taken after 59 ½ and if it has been five tax years or more since January 1st of the year you first contributed to the Roth 403(b). Furthermore, withdrawals may only be taken if you are eligible to take distributions from your 403(b) (separation from service, death, disability).

Distributions from a Roth IRA follow a specific order. First, contributions may be taken anytime and are always tax free. Next, withdrawals of conversion amounts and earnings are typically tax free if you are over 59 ½ and the applicable five-year rules are satisfied. The five-year rule applies to your oldest Roth IRA.

Rollovers. It is possible to rollover your Roth 403(b) account, which is still within the 5-year waiting period, into a Roth IRA that has already met the 5-year waiting rule to create liquidity. Typically, you would need to be either separated from service or over 59 ½ to be able to transfer your 403(b) account to an IRA.

Required Minimum Distributions. One of the disadvantages of a Roth 403(b) is that the owner must make withdrawals to satisfy required minimum distributions (RMDs). RMDs for Roth 403(b) accounts begin when a participant turns age 70 ½ (unless still employed).

However (currently), withdrawals are not required during a Roth IRA owner's lifetime. Thus, a Roth IRA can be passed down generations without any distributions being made.

The ability of a high wage earner to create a retirement "bucket" that will someday provide a tax-free withdrawal may be extremely valuable. It is for this reason that Roth 403(b) contributions could be appropriate.

1. Modified Adjusted Gross Income

Consider how you may put Roth accounts to use to improve your financial future.

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Eric is a managing partner of the independent wealth management practice, Wealth Impact Advisors, LLC. He has provided financial guidance to medical professionals, business owners and families for over two decades. He is proud to serve clients in a fiduciary capacity as a CERTIFIED FINANCIAL PLANNER™ practitioner and an Accredited Investment Fiduciary®.

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