TRADITIONAL K VS. ROTH K: TIME FOR ANOTHER LOOK

Presented By: Charles M. Lax, Esq.

I. THE BASICS

A. Traditional K vs. Roth K

1. Similarities

a. Contribution limits are the same. For 2020 the contribution limit is $19,500 and for participants age 50 and over a “catch-up” additional contribution of $6,500 is permitted.

b. The required minimum distribution rules are the same. Distributions must begin at age 72 (or 70 1/2 if you turned 70 1/2 in 2019 or earlier).

c. Distributions in either case may not be made until termination of employment, death, disability or plan termination; however, in-service distributions may be made in the case of hardship or reaching age 59 1/2.

d. Earnings accumulate tax free within the plan for both Roth K and Traditional K contributions.

2. Differences

a. Contributions to Traditional K plans are made with “pre-tax dollars”, while contributions to Roth K plans are made with “after-tax dollars.”

b. Distributions from Traditional K plans are fully taxable (on both contributions and earnings). Distributions from Roth K plans are not taxable (a qualified distribution) if:

i. The participant has reached age 59 1/2; died or become disabled; and

ii. The participant has held the Roth K account for more than five years (the holding period begins on the January 1st of the year the first Roth K contribution was made).

If the distribution is not a qualified distribution, a portion will be taxable (and possibly subject to the 10% premature distribution excise tax) and a portion will be treated as a return of the participant's after-tax contribution.

B. Roth K vs. Roth IRA

1. Similarities

a. Contributions to Roth K plans and Roth IRAs are made with "pre-tax dollars."

b. Distributions from Roth K plans and Roth IRAs are not taxable (a qualified distribution) if:

i. The participant has reached age 59 1/2; died or become disabled; and

ii. The participant has held the account for more than five years (the holding period begins on the January 1st of the year for which the first Roth contribution was made).

If the distribution is not a qualified distribution, a portion will be taxable (and possibly subject to the 10% excise tax) and a portion will be treated as a return of the participant's after-tax contribution.

c. Traditional IRAs may be converted to Roth IRAs by paying the tax on the converted amount. Traditional K plan accounts may be converted to a Roth K plan account by paying the tax on the converted amount (as long as such conversion is permitted under the plan document).

2. Differences

a. The maximum contribution permitted to a Roth IRA is $6,000 in 2020 or $7,000 for individuals age 50 and over. The maximum contribution permitted to a Roth K plan is $19,500 in 2020 or $26,000 for individuals age 50 and older.

b. For Roth IRAs an individual must earn less than $139,000 as a single filer or $206,000 as married filing jointly in 2020. There are no income limits for Roth K plans.

c. Roth K plan accounts are subject to the required minimum distribution rules (age 72, or 70 1/2 for 2019). Roth IRA accounts are not subject to any required minimum distribution rules during the account holder's life.

d. Distributions from Roth IRAs (if the 5-year period was not met) will be deemed a return of contributions before a distribution of income. Distributions from Roth Ks (if the 5-year period was not met) will be deemed a return of contributions and income.

C. See Attachment 1 – Roth Comparison Chart

II. <u>SOME SPECIAL RULES YOU NEED TO UNDERSTAND TO DETERMINE THE APPROPRIATE 5-YEAR PERIOD FOR ROTH IRAs and ROTH Ks</u>

A. The 5-year period begins on the first day of the tax year for which the contribution is made. Thus for a contribution to a Roth IRA that is made in February of 2021 for the year of 2020, the 5-year period will start on January 1, 2020 and end of January 1, 2025.

B. With regard to the conversion of Traditional IRAs to Roth IRAs, each conversion starts a new 5-year period. In this case, the 5-year period starts running on the first day of the tax year in which the conversion was made.

C. For Roth K plans the 5-year period starts on the first day of the year, the first Roth K contribution is made.

D. A distribution from a Roth K plan that is rolled into a new Roth IRA account starts the 5-year period over again.

1. If the Roth IRA account already existed, then the 5-year period relates back to the establishment of the Roth IRA account.

2. This is a frequent technique to postpone RMDs from Roth K plans.

III. <u>A USEFUL TOOL: THE ROTH IN-PLAN ROLLOVER</u>

A. An in-plan Roth rollover is a technique where non-Roth accounts can be converted to a Roth account in a 401(k) plan.

B. This technique is available only in 401(k) plans that allow for in-plan rollovers.

C. This is a valuable planning tool that allows participants to select a year and amount they wish to convert. Presumably, it would be used when the participant wants the advantage of a low tax bracket (or the likelihood of future increased tax brackets) by paying the tax currently on the converted amount.

D. If the plan permits it, the participant may convert the following accounts:

1. Traditional K accounts (elective deferrals)

2. Matching contributions

3. Rollover contributions

4. Profit sharing contributions

5. The earnings on the above contributions

E. Other rules

1. There is no tax withholding on an in-plan rollover. The tax responsibility is borne by the participant.

2. There is no excise tax on early distributions.

3. No spousal consents are needed.

IV. <u>WHICH IS BETTER: ROTH K OR TRADITIONAL K</u>?

A. Why pick Traditional K?

1. The contributions are not currently taxable. If dollars are "dear," this will allow the participant to make the largest contribution at the smallest out of pocket cost.

2. If tax rates are going to fall in the future, have the distributions taxed at a lower rate at that time than the contributions will be taxed at currently. Don't forget to consider state tax rates in this determination.

3. If the participant will be in a lower tax bracket later in life (whether rates fall or not) because of a decline in taxable income, have the distributions taxed at a lower rate at that time than the contributions will be taxed at currently. Don't forget to consider state tax rates in this determination.

4. By initially making Traditional K contributions the participant has greater control and flexibility over when to pay the taxes by utilizing in-plan roll over opportunities (in years when tax brackets or taxable income are low).

B. Why pick Roth K?

1. If tax rates are going to increase in the future, have current contributions taxed at lower rates while making distributions tax free. Don't forget to consider state tax rates in this determination.

2. If the participant will be in a higher tax bracket later in life because of increased taxable income, have the contributions taxed currently at a lower rate than the distributions would be taxed at later on in life. Don't forget to consider state tax rates in this determination.

3. Roth K accounts can be rolled to Roth IRAs which are not subject to required minimum distribution rules. This provides a longer period in which the entire account can sit in a tax-free accumulation vehicle.

4. Even though most "stretch IRAs" have been eliminated, a Roth IRA provides a great death benefit because the beneficiary will likely pay no tax on the distributions.

C. Why pick both Traditional K and Roth K?

1. A strategy used by some individuals is to not only diversify their investments in retirement accounts but to also diversify the tax risk.

2. In cases where the taxpayer doesn't have a crystal ball and can't/won't make a determination of their tax bracket 20, 30, 40 or more years in the future, allocating a portion of their IRA contribution or 401(k) contribution to Roth and a portion to Traditional may be the best strategy.

V. <u>WILL THE ELECTION HAVE AN IMPACT ON THE TRADITIONAL K VS. ROTH K DILEMMA</u>?

A. The obvious impact of the election which will be based on which candidate's tax plan will cause tax rates to increase the most and how much of an increase it will mean.

1. For taxpayers who will be in higher tax brackets when they retire or take distributions than when the contributions are made or converted from Traditional K to Roth K, Roth K will look like a better alternative.

2. There is a strong belief that with government deficits exploding, the election of either candidate will likely lead to higher future tax rates.

3. Some tax planners are already recommending that if possible consider converting all or a portion of Traditional K accounts to Roth K accounts by an in-plan rollover before the end of 2020 to take advantage of current low tax rates.

B. Is "rothification" of 401(k) plans coming?

1. Rothification or the elimination of pre-tax contributions to 401(k) plans was seriously considered by the Trump administration in 2017 in conjunction with the Tax Cuts and Jobs Act. In actuality, a form of rothification was previously considered by the Obama administration in 2015.

2. The obvious attractiveness of the concept is that it will immediately increase tax revenues in the short term. It was estimated that rothification would generate more than $100 billion of new income tax revenues annually in the early years.

3. Since the impact of tax legislation is only "scored" over 10 years, it becomes attractive to the then current administration.

4. Obviously the full impact of rothification must be scored over the life of the 401(k) account to tell the whole story.

5. Adding to the controversy were a number of studies that concluded rothification would severely reduce retirement savings. The presumption was that the amount paid currently in taxes for the contribution would lead to a direct reduction in the amount being saved.

6. The study then concluded that this would also result in other adverse consequences such as:

   a. Workers would work until later ages

   b. Retirees would spend less on consumption

7. While there was a real attempt to include rothification, it was removed from the legislations.

C. The Biden proposal to modify 401(k) plan tax breaks:

1. The premise is that the tax break of a 401(k) plan contribution is skewed in favor of higher income families (because the tax savings is greater for higher income families).

2. Biden has proposed equalizing the tax benefits by utilizing a uniform tax credit for all taxpayers.

3. Analysts have estimated that tax credit at approximately 26%.

4. The belief is that a uniform tax credit would provide greater incentive for lower earning taxpayers to save larger amounts for retirement than they do today.

5. For many taxpayers, a 26% tax credit would effectively create a federal subsidy of a portion of their retirement plan contribution.

6. For example, assume a single taxpayer making $40,000 a year and in a 12% tax bracket contributes 10% of his pay to a 401(k) plan. Under the current system, his tax would be approximately $4,320 ($40,000 - $4,000 = $36,000 x 12% = 4,320). If he received a 26% tax credit, his tax would be approximately $3,760 ($40,000 x 12% = $4,800 – ($4,000 x 26%) = $3,760. Thus, he receives a $560 subsidy ($4,320 - $3,760 = $560).

7. For the highest earning taxpayers, the limited credit (rather than a full deduction might provide further incentive to opt for Roth K contributions. This would make their distributions non-taxable while forgoing limited tax benefits at the time the contribution is made.

IRS

Roth Comparison Chart

Roth 401(k), Roth IRA, and Pre-tax 401(k) Retirement Accounts

	Designated Roth 401(k)	Roth IRA	Pre-Tax 401(k)
Contributions	Designated Roth employee elective contributions are made with ***after-tax dollars***.	Roth IRA contributions are made with ***after-tax dollars***.	Traditional, pre-tax employee elective contributions are made with ***before-tax dollars***.
Income Limits	No income limitation to participate.	Income limits: • 2020 - modified AGI married $206,000/single $139,000 • 2019 - modified AGI married $203,000/single $137,000	No income limitation to participate.
Maximum Elective Contribution	*Aggregate** employee elective contributions limited to $19,500 in 2020 and $19,000 in 2019 (plus an additional $6,500 in 2020 and $6,000 in 2019 for employees age 50 or over).	Contribution limited to $6,000 plus an additional $1,000 for employees age 50 or over in 2019 and 2020.	Same aggregate* limit as Designated Roth 401(k) Account
Taxation of Withdrawals	Withdrawals of contributions and earnings are **not** taxed provided it's a **qualified distribution** – the account is held for at least 5 years and made: • On account of disability, • On or after death, or • On or after attainment of age 59½.	Same as Designated Roth 401(k) Account and can have a qualified distribution for a first time home purchase.	Withdrawals of contributions and earnings **are** subject to Federal and most State income taxes.
Required Distributions	Distributions must begin no later than age 72 (age 70 ½ if reached age 70 ½ before January 1,	No requirement to start taking distributions while	Same as Designated Roth 401(k) Account.

2020), unless still working and not a 5% owner.	owner is alive.

* This limitation is by individual, rather than by plan. You can split your annual elective deferrals between designated Roth contributions and traditional pre-tax contributions, but your combined contributions can't exceed the deferral limit - $19,500 in 2020 and $19,000 in 2019 ($26,000 in 2020 and $25,000 in 2019 if you're eligible for catch-up contributions).

Page Last Reviewed or Updated: 20-Feb-2020