LM Federal Credit Union
Aaron Welch, RFC
Financial Advisor
1200 E Joppa Road, Suite G
Towson, MD 21286
667-308-2724
awelch@moneyconcepts.com

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Wealth Management & Financial Planning Services

The Roth 401(k)

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Employers can offer 401(k) plan participants the opportunity to make Roth 401(k) contributions. If you're lucky enough to work for an employer who offers this option, Roth contributions could play an important role in maximizing your retirement income.

What is a Roth 401(k)?

A Roth 401(k) is simply a traditional 401(k) plan that accepts Roth 401(k) contributions. Roth 401(k) contributions are made on an after-tax basis, just like Roth IRA contributions. This means there's no up-front tax benefit, but if certain conditions are met, your Roth 401(k) contributions and all accumulated investment earnings on those contributions are free from federal income tax when distributed from the plan. [403(b) and 457(b) plans can also allow Roth contributions.]

Who can contribute?

Unlike Roth IRAs, where you can't contribute if you earn more than a certain dollar amount, you can make Roth contributions, regardless of your salary level, as soon as you are eligible to participate in the 401(k) plan. And while a 401(k) plan can require employees to wait up to one year before they become eligible to contribute, many plans allow you to contribute beginning with your first paycheck.

How much can I contribute?

There's an overall cap on your combined pre-tax and Roth 401(k) contributions. In 2023, you can contribute up to $22,500 ($30,000 if you're age 50 or older) to a 401(k) plan. You can split your contribution between Roth and pre-tax contributions any way you wish. For example, you can make $10,000 of Roth contributions and $12,500 of pre-tax 401(k) contributions. It's up to you. But keep in mind that if you also contribute to another employer's 401(k), 403(b), SIMPLE, or SAR-SEP plan, your total contributions to all of these plans — both pre-tax and Roth — can't exceed $22,500 in 2023 ($30,000 if you're age 50 or older). It's up to you to make sure you don't exceed these limits if you contribute to plans of more than one employer.

Can I also contribute to an IRA?

Yes. Your participation in a 401(k) plan has no impact on your ability to contribute to an IRA (Roth or traditional). You can contribute up to $6,500 to an IRA in 2023 ($7,500 if you're age 50 or older). Your ability to contribute to a Roth IRA may be limited if your "modified adjusted gross income" (MAGI) exceeds certain levels. Similarly, your ability to make deductible contributions to a traditional IRA may be limited if your MAGI exceeds certain levels and you (or your spouse) participate in a 401(k) plan.

Are distributions really tax free?

Because your Roth 401(k) contributions are made on an after-tax basis, they're always free from federal income tax when distributed from the plan. Investment earnings on your Roth contributions are tax free if you meet the requirements for a "qualified distribution."

In general, a distribution from your Roth 401(k) account is qualified if it satisfies both of the following requirements:

- It's made after the end of a five-year waiting period
- The payment is made after you turn 59½, become disabled, or die

The five-year waiting period for qualified distributions starts on January 1 of the year you make your first Roth contribution to the 401(k) plan. For example, if you make your first Roth contribution to your employer's 401(k) plan in December 2023, your five-year waiting period begins January 1, 2023, and ends on December 31, 2027. If you participate in more than one Roth 401(k) plan, your five-year waiting period is generally determined separately for each employer's plan. But if you change employers and directly roll over your Roth 401(k) account from your prior employer's plan to your new employer's Roth 401(k) plan (assuming the new plan accepts rollovers), the five-year waiting period for your new plan starts instead with the year you made your first contribution to the earlier plan.

If your distribution isn't qualified (for example, if you receive a payout before the five-year waiting period has elapsed), the portion of your distribution that represents investment earnings on your Roth contributions will be taxable, and will be subject to a 10% early distribution penalty unless you're 59½ (55 in some cases) or another exception applies. You can generally avoid taxation by rolling all or part of your distribution over into a Roth IRA or into another employer's Roth 401(k) or 403(b) plan, if that plan accepts Roth rollovers. [State income tax treatment of Roth 401(k) contributions may differ from the federal rules.]

If you contribute to both a Roth 401(k) and a Roth IRA, a separate five-year waiting period applies to each. Your Roth IRA five-year waiting period begins with the first year that you make a regular or rollover contribution to any Roth IRA.

What about employer contributions?

Employers don't have to contribute to 401(k) plans, but many will match all or part of your contributions. Your employer can match your Roth contributions, your pre-tax contributions, or both. Your 401(k) plan may require up to six years of service before you fully own employer matching contributions. [Note: If your plan is a SIMPLE 401(k) plan, a safe-harbor 401(k) plan, or includes a qualified automatic contribution arrangement (QACA) your employer is required to make a contribution on your behalf, and special vesting rules apply.]

Should I make pre-tax or Roth 401(k) contributions?

When you make pre-tax 401(k) contributions, you don't pay current income taxes on those dollars (which means more take-home pay compared to an after-tax Roth contribution of the same amount). But your contributions and investment earnings are fully taxable when you receive a distribution from the plan. In contrast, Roth 401(k) contributions are subject to income taxes up front, but qualified distributions of your contributions and earnings are entirely free from federal income tax.

Which is the better option depends upon your personal situation. If you think you'll be in a similar or higher tax bracket when you retire, Roth 401(k) contributions may be more appealing, since you'll effectively lock in today's lower tax rates. However, if you think you'll be in a lower tax bracket when you retire, pre-tax 401(k) contributions may be more appropriate. Your investment horizon and projected investment results are also important factors. A financial professional can help you determine which course is best for you.

Whichever you choose — Roth or pre-tax — make sure you contribute as much as necessary to get the maximum matching contribution from your employer. This is essentially free money that can help you pursue your retirement goals.

What happens when I terminate employment?

When you terminate employment, you generally forfeit all employer contributions (and earnings on them) that haven't vested. "Vesting" means that you own the contributions and any associated earnings. Your contributions, Roth and pre-tax, are always 100% vested. But your 401(k) plan may require up to six years of service before you fully vest in employer matching contributions (although some plans have a much faster vesting schedule).

When you terminate employment, you can generally leave your money in your 401(k) plan, although some plans require that you withdraw your funds when you reach the plan's normal retirement age (typically age 65).Your plan may also "cash you out" if your vested balance is $5,000 or less, but if your payment is more than $1,000, the plan must generally roll your funds into an IRA established on your behalf, unless you elect to receive your payment in cash. [This $1,000 limit is determined separately for your Roth 401(k) account and the rest of your funds in the 401(k) plan.]

You can also roll all or part of your Roth 401(k) dollars over to a Roth IRA, and your non-Roth dollars to a traditional IRA. You may also be able to convert your non-Roth dollars to a Roth IRA, but income taxes will apply to any tax-deferred amounts in the year of conversion. You may also be able to roll your funds into another employer's plans that accepts rollovers.

Finally, you may also be able to take a cash distribution of your contributions and earnings, as well as any vested employer amounts. However, keep in mind that any tax-deferred funds will be subject to income taxes and a possible 10% penalty tax if you're under age 59½ and an exception does not apply.

Note: *When considering a rollover, to either an IRA or to another employer's retirement plan, you should consider carefully the investment options, fees and expenses, services, ability to make penalty-free withdrawals, degree of creditor protection, and distribution requirements associated with each option.*

What else do I need to know?

- Like pre-tax 401(k) contributions, your Roth 401(k) contributions and investment earnings can generally be paid from the plan only after you terminate employment, attain age 59½, become disabled, or die.
- If your plan allows loans, you may be able to borrow a portion of your vested balance, up to specified limits.
- You may be able to take a hardship withdrawal if you (or your spouse, dependents, or primary beneficiary) have an immediate and heavy financial need. But this should be a last resort — hardship distributions are generally taxable to you and a 10% penalty may apply to the taxable amount if you're not yet age 59½, unless an exception applies.
- Distributions from your plan before you turn 59½ (55 in some cases) may be subject to a 10% early distribution penalty unless an exception applies.
- Depending on your income, you may be eligible for an income tax credit of up to $1,000 for amounts you contribute to the 401(k) plan.
- Your assets are generally fully protected from creditors.

Employers aren't required to make Roth contributions available in their 401(k) plans. So be sure to ask your employer if they are considering adding this exciting feature to your 401(k) plan.