Roth IRA vs. Designated Roth Accounts

What are Roth accounts?

Roth IRAs and designated Roth accounts within a qualified plan that has elective deferral provisions (DRACs) are retirement accounts that differ from other IRAs and qualified plans in a couple main ways:

- Roth account contributions are never tax-deductible and always come from after-tax dollars
- Qualified distributions from a Roth account are completely income tax and penalty free (including earnings)

Compare this with other IRAs and qualified plans, where contributions can be made pre-tax and distributions are typically taxable. Roth IRAs and DRACs differ from those other retirement accounts in other ways, too. Furthermore, they also differ from each other. This piece breaks out the differences between Roth IRAs and DRACs.

CHARACTERISTIC	ROTH IRA	DRAC
Who can set one up?	Anyone with earned income below income limits (see below) OR anyone with an IRA they'd like to convert[1]	Anyone with access to an employer-sponsored plan that offers a DRAC option
How much can be contributed annually?	Lesser of $6,000 (plus $1,000 catch-up contribution if 50+ years old)[2] or compensation for the year, subject to income limits (see below)	Lesser of $19,500 (plus $6,500 catch-up contribution if 50+ years old)[3] or compensation for the year[4]
Income limits for making maximum annual contributions	≥ $208,000 if married filing jointly; ≥ $140,000 if single (phaseouts resulting in reduced contribution limits start at $198,000 and $125,000, respectively)[5]	No income limits
Subject to ERISA?[6]	No	Yes

[1] Treas. Reg. § 1.408A-10, A-2.
[2] Notice 2020-79. This figure is reduced by any contributions made to traditional IRAs in the same tax year.
[3] *Id*. This figure represents the limit on employee elective salary deferrals. These are contributions an employee makes in lieu of salary to certain retirement plans. Elective salary deferrals are not the only way to get money into a qualified plan, but they are the most common. This figure is reduced by any contributions made to other qualified plans with elective deferral provisions in the same tax year.
[4] Employer-sponsored plans can impose further limits on an employee's ability to contribute (for example, cap an employee's ability to contribute at 50% of salary).
[5] *Id*.
[6] Employer sponsored plans are typically governed by ERISA, a federal law. IRAs, on the other hand, are governed by state law. This can be a significant difference for several reasons. ERISA-governed plans, for example, receive automatic unlimited bankruptcy creditor protection and require spousal consent to name anyone but a spouse as the beneficiary of a participant's plan.

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Definition of a qualified distribution (income tax & penalty free distributions)	Satisfy Roth IRA five-year rule (see below) AND at least one of the following triggering events[7] apply: • Reach age 59 ½ • Disability • Death • Qualified first-time homebuyer (up to $10,000)	Satisfy DRAC five-year rule (see below) AND at least one of the following triggering events[8] apply: • Reach age 59 ½ • Disability • Death
Five-year rule	Five years have passed since January 1 of the first year there was a contribution to *any* Roth IRA belonging to the participant[9]	Five years have passed since the first year the taxpayer contributed to a DRAC *in that specific plan*[10]
Rollover from Roth IRA permitted?	Yes	No
Rollover from DRAC permitted?	Yes, if originating plan allows for distributions	Yes, if receiving plan allows
Effect of rollover from DRAC on five-year rule	None (no holding period carryover from DRAC)	Holding period from older DRAC may carry over[11]
Effect of rollover from DRAC on characteristics of rolled funds	• If rollover was a qualified distribution from DRAC, entire amount (including earnings) becomes part of Roth IRA basis[12] • If rollover was not a qualified distribution from DRAC, basis in DRAC becomes part of Roth IRA basis, earnings remain earnings[13]	• If rollover was a qualified distribution from first DRAC, entire amount (including earnings) becomes part of second DRAC's basis[14] • If rollover was not a qualified distribution, the earnings portion in the original account retains its character as earnings in the receiving account (versus getting added to basis).[15]

[7] § 408A(d)(2)(A). Note that these triggering events include some, but not all, of the exceptions to the 10% early withdrawal penalty. Compare § 408A(d)(2)(A) with § 72(t)(2). Note also that corrective distributions are never qualified, even if they meet both the holding period and triggering event tests. Treas. Reg. § 1.408A-6, A-1(d), A-4, A-9(e).

[8] § 402A(d)(2)(A).

[9] This five-year holding period still applies even after a participant dies. However, luckily, the decedent's holding period gets added to the beneficiary's holding period. Treas. Reg. § 1.408A-6, A-7(a).

[10] However, a direct rollover from another DRAC permits carrying a longer holding period from the first DRAC. This is not the case if the rollover was indirect. § 402A(d)(2)(B)(i); Notice 2013-74, A-8.

[11] This depends on whether the rollover was direct or indirect. See prior footnote.

[12] Reg. 1.408A-10, A-3(a). It's also possible to preserve basis in excess of account value (if the account value has dipped below original contributions) in the event of a rollover from a DRAC. Reg. § 1.408A-10, A-3(b).

[13] *Id*. Note that rollovers from DRACs are either entirely treated as regular contributions or earnings, or some combination of the two, and never as conversion contributions.

[14] It's also possible to preserve basis in excess of account value (if the account value has dipped below original contributions) in the event of a direct rollover of the entire originating account's value. Reg. 1.402A-1, A-6(b).

[15] *See* Reg. 1.402A-1, A-6(a).

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How distributions are characterized	Distributions are deemed to come from these categories in the following order[16] 1. Regular contributions (no income tax or 10% penalty apply) 2. Conversion contributions[17] (no income tax, although 10% penalty applies if it hasn't been more than five years since January 1 of the year in which that conversion was made[18], unless an exception to the 10% penalty applies.[19] Note that this is a different five-year rule from the one discussed above that is specific to conversion contributions). 3. Earnings a. If a qualified distribution, no tax or penalty b. If non-qualified distribution, tax and 10% penalty apply	Distributions represent after-tax (basis) and pre-tax (earnings) money in proportion to the DRAC[20] (the usual "cream-in-the-coffee" rule that applies to traditional IRA and qualified plan distributions)
When do lifetime required minimum distributions (RMDs) begin?	Never because no lifetime RMDs are required	Generally, April 1 of the calendar year following the year in which the IRA owner turns age 72 or separates from service, whichever is later[21]

As you assist clients with their Roth accounts, it's important to keep these nuances in mind. Different contribution limits and distribution rules can lead to different tax outcomes and impact your client's financial situation.

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[16] For more information on the ordering rule and a Roth IRA distribution flow chart, see *Roth IRA Distributions During Owner's Life* in the Advanced Planning Library.

[17] Note that conversion contributions can only come from rollovers from traditional IRAs or qualified plans. Money that comes from a DRAC or another Roth IRA are characterized as either regular contributions or earnings. Thus, the five-year rule does not apply to amounts rolled over from a DRAC that were allocable to basis in the DRAC (because those amounts are treated as regular contributions in both the DRAC and the receiving Roth).

[18] § 408A(d)(3)(F); Reg. § 1.408A-6, A-5(b); Notice 2008-30, A-3.

[19] See § 72(t)(2) for a list of exceptions.

[20] DRACs within a single plan are aggregated, but luckily the DRAC is not aggregated with any traditional accounts within the same employer plan.

[21] The required beginning date is April 1 following the year in which you turn 70 ½ if you were born before July 1, 1949. If you were born after July 1, 1949, your required beginning date is April 1 following the year in which you turn 72. For those who don't own more than 5% of the business sponsoring the plan, it may be possible to delay the required beginning date to April 1 following the year in which you separate from service if your plan allows. More than 5% owners do not have this option.

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