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View From McDermott: Expanded In-Plan Conversion Opportunities Will Boost Roth 401(k) Balances

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The number of defined contribution plans (including 401(k), 403(b) or 457(b) plans) with a Roth feature has grown significantly in recent years. Roth 401(k) is gaining popularity due in part to tax hedging or tax diversification strategies. Since the federal and state tax rates that apply at retirement are unknown, a participant can hedge future tax exposure by making at least some portion of his or her retirement savings as Roth 401(k) contributions. Other participants want greater retirement security with a large portion of their retirement savings not subject to income taxes. Some high net worth participants want to pass tax-free investments to their beneficiaries.

Whatever the reasoning, Roth 401(k) is gaining traction in employer-sponsored defined contribution plans. According to a survey of 400 plan sponsors in October 2013, 50 percent offered a Roth option in their 401(k) plans, as opposed to 11 percent only five years earlier.[1] The number of participants with access to Roth features, and the size of their Roth 401(k) balances, should continue to surge following the issuance of new IRS guidance[2] that greatly expands participants' ability to convert retirement savings to Roth balances.

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Roth History

Roth 401(k) is an outgrowth of the Roth IRA and a creature of the Internal Revenue Code.[3] Plan sponsors have been permitted to adopt Roth features in their 401(k) plans since 2006, following enactment of the Economic Growth and Tax Relief Act of 2001. Prior to that, the Taxpayer Relief Act of 1997 established the Roth IRA, but the Roth IRA has lower annual contribution limits than the Roth 401(k) and has maximum annual income limits for contributing individuals that don't apply to a Roth 401(k). However, while employees

[1] ''2013 Trends & Experience in Defined Contribution Plans: An Evolving Retirement Landscape Highlights,'' Oct. 30, 2013, p. 1, available at http://www.aon.com/attachments/human-capital-consulting/2013_report_Trends-Experience-DC-Plans_Highlights.pdf (last visited March 24, 2014). In 2012, 56 percent of participants in Vanguard's defined contribution prototype plans also were offered a Roth option. ''Research Note: Roth adoption and the new in-plan conversion feature,'' May 15, 2013, p. 2 available at https://pressroom.vanguard.com/nonindexed/5.15.2013_Roth_Adoption_and_the_New_Inplan_Feature.pdf (last visited March 24, 2013).

[2] The guidance relates to the expansion of the rollover rules under 26 U.S.C. § 402A(c)(4)(E), as added by Section 902 of the American Taxpayer Relief Act of 2012 (ATRA), Pub. L. No. 112-240 (Jan. 4, 2013); *see also* IRS Notice 2013-74, 2013-52 I.R.B. 819 (Dec. 11, 2013).

[3] 26 U.S.C. § 402A.

can make Roth IRA contributions without employer involvement, employees may only make Roth 401(k) contributions if their employer adopts a Roth feature in their 401(k) plan.

Comparing Roth 401(k), Pretax 401(k) and After-Tax Contributions

Roth 401(k), pretax 401(k) and after-tax contributions all share certain features, such as a plan sponsor's ability to make a matching contribution and to offer participant loans. Although legally not required, many plan sponsors provide identical matching contributions on pretax 401(k) and Roth 401(k) contributions, and allow participants to borrow money from their defined contribution plan based their Roth 401(k), pretax 401(k) and after-tax contribution balances.[4]

However, the Roth 401(k) contribution is essentially a hybrid contribution because it shares some features with pretax contributions and some features with after-tax contributions. For example, both Roth 401(k) contributions and pretax 401(k) contributions have the same maximum contribution limits, nondiscrimination testing and in-service withdrawal restrictions.

Specifically, in 2014, the maximum amount that a participant may make in both Roth 401(k) contributions and pretax 401(k) contributions is limited to $17,500, and the maximum amount of both Roth 401(k) catch-up contributions and pretax 401(k) catch-up contributions is limited to $5,500.[5] Likewise, Roth 401(k) contributions are subject to the same average deferral percentage (ADP) nondiscrimination test as pretax 401(k) contributions.[6] Also like pretax 401(k) contributions, Roth 401(k) contributions can be withdrawn during employment if the employer's plan permits and if the participant is over age 59-1/2, becomes disabled or experiences a financial hardship.[7]

Even though Roth 401(k) contributions share many traits with pretax 401(k) contributions, Roth 401(k) contributions also share a few traits with after-tax contributions. Both after-tax contributions and Roth 401(k) contributions are included in a participant's taxable income in the year they are contributed to the plan. Because Roth 401(k) contributions are included in the participant's taxable wages[8] when made to the defined contribution plan, to reach the maximum contribution limit of $17,500, more than this amount is reduced from the participant's wages ($17,500 plus taxes owed on the contributions).

Unique Tax Rules for Distributions and Rollovers

In certain respects, Roth 401(k) contributions are different from both pretax and after-tax contributions. Specifically, Roth 401(k) contributions have unique tax rules for distributions and for rollovers. Although Roth 401(k) contributions are taxed upon initial contribution, if a Roth 401(k) distribution is ''qualified,'' then any earnings on the Roth 401(k) contributions can escape taxation.[9]

A Roth 401(k) distribution is qualified only if the participant's Roth 401(k) account is at least five years old and if the Roth 401(k) distribution occurs after the participant reaches age 59-1/2, becomes disabled, or dies.[10] The five-year holding period for a Roth 401(k) contribution begins January 1 of the first year a participant makes a Roth 401(k) contribution.[11] In case of a participant's death, a distribution does *not* automatically become qualified, since the distribution also must comply with the five-year holding rule. If the Roth 401(k) account of the deceased is less than five years old, the death distribution will only be qualified if either: (i) the alternate payee or spousal beneficiary rolls the distribution into a designated Roth account maintained by his or her own employer,[12] or (ii) the beneficiary keeps the Roth 401(k) contributions in the plan until the five-year holding period has passed.

Under another unique tax distribution rule, Roth 401(k) contributions can evade minimum distribution rules at age 70-1/2. Although Roth 401(k) contributions in a defined contribution plan are subject to minimum distribution requirements at age 70-1/2, a participant can avoid the normal minimum distribution requirements by choosing to directly roll over his or her Roth 401(k) contributions and applicable earnings to a Roth IRA.[13]

Roth 401(k) contributions also have unique tax rollover rules. Roth 401(k) rollover rules differ from those of all other contributions with a distinction between direct rollovers and indirect 60-day rollovers. A participant can make a direct rollover of both Roth 401(k) balances and earnings to either a Roth IRA or another Roth 401(k) account.[14] However, if a participant receives an indirect rollover (a direct distribution to the participant), then within 60 days the participant may rollover *only* the taxable earnings to another Roth 401(k) account.[15] In short, the participant cannot rollover the Roth 401(k) contributions themselves using a 60-day rollover. Therefore, indirect 60-day rollovers of Roth 401(k) contributions can be a bad idea for tax purposes because the distributed Roth 401(k) contributions no longer earn tax-free income. Another Roth oddity is the complicated carryover rules that relate to the five-year holding period on Roth 401(k) rollovers. The five-year holding period never carries over to a Roth IRA,[16] and the prior holding period only transfers to a Roth 401(k) account when the rollover is completed as a direct rollover between two defined contribution plans.

Advent of Roth 401(k) Conversions

The Small Business Jobs Act of 2010 introduced in-plan Roth 401(k) conversions (termed ''in-plan rollovers'' under IRS guidance) for distributions after Sept.

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[4] Treas. Reg. §§ 1.401(m)-1(a)(2) and 1.401(a)-13(d)(2).

[5] Roth contributions are treated as elective deferrals under 26 U.S.C § 402(g)(3) and subject to the same annual maximum limits as elective deferrals made to a 401(k) plan. *See also* 26 U.S.C. § 402A(a)(1), (c)(2); Treas. Reg. § 1.401(k)-1(f)(4) and 26 U.S.C. § 414(v)(1), (5).

[6] Treas. Reg. § 1.401(k)-1(f)(4)(i).

[7] *Id.*

[8] 26 U.S.C. § 402A(a)(1).

[9] *Id.;* 26 U.S.C. § 402A(d).

[10] 26 U.S.C. § 402A(d); 26 U.S.C. § 408A(d)(2).

[11] 26 U.S.C. § 402A(d)(2)(B)(i); Treas. Reg. § 1.408A-6, Q&A-2.

[12] 26 U.S.C. § 1.402(c)(9); Treas. Reg. § 1.402A-1, Q&A-4(d).

[13] Treas. Reg. § 1.408A-6, Q&A-14.

[14] Treas. Reg. § 1.402A-1, Q&A-5.

[15] *Id.*

[16] Treas. Reg. § 1.402A-1, Q&A-4(b)

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27, 2010.[17] An in-plan Roth 401(k) conversion is the conversion of a participant's existing non-Roth account balance into a Roth 401(k) account balance within the sponsor's plan. In other words, the conversion changes the tax character of the participant's non-Roth money to Roth 401(k) money. In-plan Roth 401(k) conversions originally were available for any of the participant's contributions in a defined contribution plan as long as these amounts were both vested and otherwise eligible for distribution to the participant.[18]

At the beginning of 2013, the American Taxpayer Relief Act significantly relaxed the in-plan conversion rules.[19] Plan sponsors that permitted Roth 401(k) contributions also could allow in-plan Roth 401(k) conversions of account balances that were not immediately distributable to the participant. Later guidance confirmed that these nondistributable balances still must be vested to be eligible for an in-plan Roth 401(k) conversion.[20]

Mechanics of Roth 401(k) Conversions

Congress's purpose in expanding in-plan Roth conversion opportunities was to raise revenue. Amounts converted to Roth 401(k) contributions, other than traditional after-tax contributions, are subject to tax in the year of conversion. Although in-plan Roth 401(k) conversion amounts generally are subject to immediate taxation, employers aren't required to withhold income tax on converted amounts.[21] In this case, a participant may face a large tax bill for the conversion year unless the participant requests an increase in income tax withholding or makes estimated tax payments. The plan sponsor reports an in-plan Roth 401(k) conversion on Form 1099-R, which is the same form used for an actual plan distribution. Participants report the Roth 401(k) conversion as a retirement plan distribution on their personal tax return.

A participant can implement a Roth 401(k) conversion without spousal consent.[22] When a participant converts a non-Roth balance to Roth 401(k) balance, any distribution restrictions that applied before conversion continue to apply after conversion.[23] For example, during employment a participant can withdraw pretax 401(k) contributions only due to hardship or attaining age 59-1/2 and only if the plan allows for such in-service withdrawals. These in-service withdrawal restrictions will continue to apply to any pretax 401(k) contributions converted to Roth 401(k) contributions.

An in-plan Roth 401(k) conversion doesn't trigger the 10 percent penalty tax that applies to early distributions before age 59-1/2.[24] However, if the converted Roth 401(k) amounts are distributed within five years of the conversion year (other than as a rollover to another Roth account or Roth IRA), then the participant may have to pay the 10 percent penalty tax that would have applied to the original conversion, which is known as the ''recapture'' rule.[25] This recapture rule for early distribution taxes is separate from the five-year holding rule that relates to qualified Roth distributions discussed above, and the two different five-year rules create confusion among participants and plan sponsors.

Issues With Roth 401(k) Conversions

As noted above, a plan sponsor must amend a 401(k) plan to permit in-plan conversions. After the plan has been amended to permit Roth 401(k) conversions, the plan sponsor will need to create and administer a separate Roth 401(k) account for participants who make conversions but who don't make other Roth 401(k) contributions. For participants who already make Roth 401(k) contributions, the converted amounts could be transferred to their existing Roth 401(k) accounts. However, since prior distribution restrictions and tax recapture rules still apply to converted Roth 401(k) amounts, a plan sponsor may need to create more than one Roth 401(k) account for a participant to ensure correct administration of distribution and tax rules.

To properly implement Roth 401(k) conversions, plan sponsors should also update summary plan descriptions, safe harbor notices (if applicable), enrollment materials, and other participant communications to reflect the new in-plan Roth 401(k) conversion feature. Also, if the feature isn't available to all plan participants, plan sponsors should make sure that the conversion feature doesn't discriminate in favor of highly compensated employees.[26]

Recent guidance provided plan sponsors clarity on some outstanding issues relating to Roth conversions.[27]

■ First, plan sponsors don't need to distribute the special tax notice under tax code Section 402(f) when a participant converts a nondistributable balance to a Roth 401(k) balance.[28]

■ Second, plan sponsors can restrict the type of participant contributions eligible for, and the frequency of, in-plan Roth conversions, which can simplify administration of Roth accounts considerably. For example, a plan sponsor could limit in-plan Roth conversions to only pretax 401(k) deferrals or permit only one Roth 401(k) conversion per participant per year.[29]

■ Third, plan sponsors can discontinue an in-plan Roth conversion feature at any time without violating the tax code's prohibition on elimination of protected benefits, as long as the timing of the plan amendment doesn't discriminate against nonhighly compensated employees.[30] Thus, plan sponsors need not make in-plan Roth conversions a permanent feature of their plans.

The new guidance also provided plan sponsors a special one-time extension on amendments to permit Roth

[17] Section 2112(a) of the Small Business Jobs Act of 2010, Pub. L. No. 111-240 (Sept. 27, 2010) added 26 U.S.C. § 402A(c)(4), effective for distributions made after Sept. 27, 2010.

[18] IRS Notice 2010-84, 2010-51 I.R.B. 872 (Nov. 29, 2010), Q&A-2.

[19] Section 902 of the ATRA added 26 U.S.C. 402A(c)(4)(E), effective for transfers made after Dec. 31, 2012.

[20] IRS Notice 2013-74, 2013-52 I.R.B. 819 (Dec. 11, 2013), Q&A-1.

[21] IRS Notice 2010-84, Q&A-8.

[22] IRS Notice 2010-84, Q&A-3.

[23] IRS Notice 2013-74, Q&A-3.

[24] 26 U.S.C. § 402A(c)(4)(ii); Treas. Reg. § 1.408A-4, Q&A-7.

[25] IRS Notice 2010-84, Q&A-12.

[26] IRS Notice 2013-74, Q&A-6.

[27] IRS Notice 2013-74. In addition to the items discussed above, IRS Notice 2013-74 provides further guidance on Roth pre-conversion amounts invested in employer stock for purposes of determining eligibility for the special tax rules on net unrealized appreciation after Roth conversion.

[28] *Id.*, Q&A-1.

[29] *Id.*, Q&A-6.

[30] *Id.*, Q&A-7.

401(k) deferrals, incoming Roth 401(k) rollovers or in-plan Roth 401(k) conversions.[31] Although generally the IRS requires a plan sponsor to amend a defined contribution plan by the end of the plan year in which Roth 401(k) features are added, the IRS has extended the deadline for adopting these amendments to Dec. 31, 2014, or the last day of the first plan year in which the amendment is effective, whichever is later. Plan sponsors who permitted Roth 401(k) deferrals, incoming Roth 401(k) rollovers or in-plan Roth 401(k) conversions in 2013 now have more time to adopt plan amendments that reflect these changes. Similarly, safe harbor plan sponsors may implement midyear in-plan Roth 401(k) conversions of otherwise nondistributable amounts until Dec. 31, 2014, and may adopt Roth amendments until Dec. 31, 2014. After Dec. 31, 2014, defined contribution plan sponsors must adopt amendments by plan year-end to reflect any of these Roth 401(k) features implemented during such year, and a safe harbor plan sponsor can implement a Roth 401(k) conversion feature only at the beginning of a plan year.

[31] *Id.*, Q&A-5.

Final Thoughts

With the expanded opportunities to convert defined contribution balances to Roth balances, we anticipate the continued growth of Roth 401(k) balances as a proportion of overall 401(k) plan balances. This growth may be particularly true for younger workers in low income-tax brackets, who may have a long time horizon during which tax-free earnings can accumulate in Roth 401(k) accounts and who may currently pay taxes at lower tax rates than expected at retirement. Given the current trends, we recommend that plan sponsors consider implementing or expanding a Roth 401(k) feature, but with a careful eye on the complex legal, tax and administrative challenges involved in implementing Roth 401(k) contributions and in permitting Roth 401(k) conversions.

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