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View From Groom: In-Plan Roth Rollovers Take on New Look



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In January 2013, Congress passed, and the president signed into law, H.R. 8, The American Taxpayer Relief Act of 2012, which extended the existing in-plan Roth rollover rules to amounts not otherwise distributable under the plan. Recent IRS Notice 2013-74 clarifies a number of open issues regarding the new (and existing) rollover feature, building on Notice 2010-84, which provided the initial round of comprehensive guidance. Importantly, the new notice, in question-and-answer format, gives plan sponsors through the end of 2014 to amend their plans for this expanded in-plan Roth rollover feature rolled out in 2013.

This rollover feature permits plans with designated Roth programs to transfer, at the participant's election, non-Roth amounts into the same plan's Roth account. This transfer is generally a taxable event, but the subsequent earnings thereon may avoid taxation altogether (as described below).

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The applicable rules for in-plan Roth rollovers—as clarified by the Notice 2013-74—are generally summarized below. While the same rules generally apply to both types of in-plan Roth rollovers—i.e., distributable and nondistributable—to the extent the rules vary, we indicate that below.

■ **Plans Covered.** This provision applies only to plans that have been amended to permit Roth elective deferrals under a Section 401(k) plan, 403(b) plan or governmental 457(b) plan.

■ **Eligible Participants.** Any participant (including an active or former participant with an account balance in the plan), spousal alternate payee or spousal beneficiary can make the election.

■ **Amounts Eligible for Conversion (varies).** The conversion applies to any type of (1) vested contributions (and earnings thereon) that are “currently distributable” and would be treated as an eligible rollover distribution if distributed, and if the plan so provides, or (2) vested contributions (and earnings thereon) that aren't “currently distributable,” if the plan so provides.

Notice 2013-74 clarifies that the expanded nondistributable election is limited to vested amounts, and includes: (1) pretax 401(k) and 403(b) deferrals, governmental 457(b) deferrals, and earnings thereon, and (2) matching, profit sharing or other nonelective employer contributions (including qualified nonelective contributions (QNECs) and qualified matching contributions (QMACs)), and earnings thereon. Thus, for an active employee who hasn't yet reached age 59-1/2, the conversion feature is available for pretax deferrals, even though these amounts wouldn't be currently distributable.

The notice also clarifies that a plan is permitted to restrict the type of contributions eligible for the in-plan Roth rollover and the frequency of the in-plan Roth rollovers, subject to the standard BRF (benefit, rights, features) nondiscrimination testing requirements under tax code Section 401(a)(4).

■ **Direct Rollovers Only (varies).** Notice 2013-74 confirms that, unlike the in-plan Roth rollover for currently distributable amounts, the expanded nondistributable amounts election is limited to a direct rollover only (i.e., indirect (or “60-day”) rollovers won't be permitted). Moreover, for nondistributable amounts, the 402(f) (rollover) notice doesn't need to reflect these rules nor be provided to the participant.

■ **Allowable In-Service Distributions (varies).** Notice 2013-74 confirms that if a plan sponsor adds this optional feature for nondistributable amounts, the same withdrawal restrictions should be imposed (e.g., retain restrictions on a prior source—such as no actual distribution of 401(k) deferrals until age 59-1/2). While the conversion election isn't subject to spousal consent or the notice to defer, it does require the participant to forgo future “net unrealized appreciation” treatment for employer stock.

■ **Record Keeping (varies).** In-plan Roth conversion amounts should be transferred (for bookkeeping purposes) to a Roth account, but as noted above, to address any withdrawal restrictions, sub-accounts may need to be established for nondistributable amounts. Importantly, if separate investment directions may be made for different accounts, they should be reviewed to assure that a participant's assets end up in the intended investments.

■ **Required Minimum Distribution Rules.** Unlike the rule that applies to Roth IRAs (and amounts rolled into a Roth IRA), a participant's plan account will continue to be subject to the lifetime required minimum distribution rules that generally require distributions to begin at age 70-1/2 (or retirement, if later) for in-plan conversions.

■ **Plan Amendment (varies by plan type).** Notice 2013-74 generally provides that the in-plan rollover feature is a discretionary amendment that must be adopted by the end of the plan year in which it is effective. However, plan sponsors of 401(a) and 457(b) plans have until Dec. 31, 2014, to adopt amendments for in-plan rollovers of nondistributable amounts offered in 2013. For safe harbor 401(k) plans, the notice provides a transition period through Dec. 31, 2014, to make midyear changes to provide in-plan Roth rollovers for nondistributable amounts. Section 403(b) plan sponsors have until the last day of the plan year in which the new in-plan Roth rollover rules are effective, or end of the remedial amendment period, whichever is later. This amendment period also covers the following related amendments: (1) adding a Roth deferral feature, (2) accepting rollovers of designated Roth accounts, and (3) permitting in-plan Roth rollovers of some or all otherwise distributable amounts. The notice doesn't, however, provide sample amendment language.

■ **Qualified Distribution.** Significant potential advantages of the in-plan Roth conversion feature are that (1) it permits participants to convert non-Roth assets into Roth assets under the current tax rates, and (2) if a later distribution qualifies as a “qualified distribution,” then the earnings that accrued after the conversion date are tax-free (i.e., never subject to federal income tax). Therefore, it is important to determine what rules apply for a “qualified distribution.” Tax code Section 402A(d) provides that in order to have a “qualified distribution,” a participant must receive a distribution:

- that is made after a five-year period (generally beginning with the first taxable year in which the

participant contributed to a Roth 401(k) account under the plan or under a prior plan that was rolled over to the current plan, or as Notice 2013-74 clarifies, the first day of the first taxable year the employee makes the in-plan Roth rollover if the conversion is the first contribution to the Roth account), and

- made on account of (i) death, (ii) disability, or (iii) after a participant reaches age 59-1/2.

■ **Reporting and Withholding (varies).** Notice 2013-74 confirms that unlike the in-plan Roth rollover for currently distributable amounts, no federal income tax can be withheld from the nondistributable converted amount. The fair market value of the converted funds will be reported on the current year Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., in box 1 (gross distribution), the taxable portion of the conversion (determined as if the amounts were actually distributed) will be reported in box 2a, with any federal income tax withheld in box 4 (not applicable for nondistributable amounts), any basis recovery will be reported in box 5, and code “G” will be entered in box 7 (“G4” for a spouse).

■ **10 Percent Tax Recapture.** If a participant takes an actual distribution of the Roth conversion amount within five years (measured from the first day of the tax year in which the conversion is made) and the participant hasn't yet reached age 59-1/2 (or doesn't meet another exception to the 10 percent early distribution tax at the time of such later distribution), the distribution would be subject to the 10 percent tax to the extent that it would have applied in the year of the conversion.

■ **Irrevocable.** All in-plan Roth rollovers are irrevocable (unlike Roth IRA conversions).

■ **Top-Heavy Status.** The in-plan Roth rollover is treated as a “related rollover” for purposes of determining the plan's top-heavy status, which means that the conversion amount must be counted in determining the present value of accrued benefits.

■ **Anti-Cutback Issue.** Notice 2013-74 clarifies that discontinuation of the in-plan Roth rollover feature doesn't violate the anti-cutback provision of Section 411(d)(6), but the timing of the amendment is subject to the nondiscrimination requirements under Treas. Reg. § 1.401(a)(4)-5. The latter warning suggests that availability of the option shouldn't coincide with the desires of the employer's owner, for example.

■ **Correction of Excess Amounts.** Notice 2013-74 clarifies that if an employee rolls over all his non-Roth funds into a designated Roth account, excess amounts (attributable to Section 402(g) limits, ADP or ACP testing) shall be distributed from the Roth account.

Now that the rules are clarified, plan sponsors may want to discuss with their record keepers the ability to add this new feature to expand on a participant's ability to obtain meaningful Roth accounts—and perhaps save taxes in the long run!