

# Roth 401(k) Plans

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This Note provides an overview of Roth 401(k) plans, also known as designated Roth plans. It discusses the benefits of providing employees with a Roth option, the after-tax treatment of designated Roth contributions and Internal Revenue Code (IRC) requirements governing Roth 401(k) plans. This Note also explains the optional in-plan rollover of distributions from traditional 401(k) accounts to Roth 401(k) accounts.

Since January 1, 2006, employers offering 401(k) retirement plans to their employees have been able to amend their plans to accept contributions on an after-tax basis, similar to Roth Individual Retirement Accounts (Roth IRAs). These Roth 401(k) plans or designated Roth accounts are authorized by IRC Section 402A, which was added to the IRC under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Designated Roth contributions grow with tax-free earnings and are distributed at retirement without triggering any future income tax liability. Although the Roth 401(k) option was intended to expire on December 31, 2010, the Pension Protection Act of 2006 extended the program indefinitely. These rules also apply to 403(b) plans and governmental 457(b) plans, with some modifications (see *Roth 403(b) and Governmental 457(b) Plans*).

This Note gives a general overview of the designated Roth option and explains:

- The benefits of using a Roth 401(k).
- The IRC requirements governing designated Roth plans.
- The treatment of contributions to and distributions from Roth 401(k) plans.
- In-plan rollovers of distributions from non-Roth accounts to Roth options within an employer's plan.
- Issues for employers to consider before implementing Roth 401(k) programs.

## BENEFITS FOR EMPLOYEE-PARTICIPANTS

A traditional 401(k) allows employee-participants to make pre-tax contributions to their accounts which are taxed when the account is distributed to the participant. Participants may contribute up to a certain amount annually (\$17,500 for 2014; \$23,000 if they are at least 50 years old) on a pre-tax basis and participants of all income levels may participate.

By contrast, a Roth IRA allows single taxpayers up to a certain adjusted gross income (\$129,000 for 2014; \$191,000 for married taxpayers) to put aside after-tax dollars in their Roth IRAs that grow without being subject to future taxes. In 2014, participants may contribute up to \$5,500 annually on an after-tax basis (\$6,500 if they are at least 50 years old).

The Roth 401(k) combines elements of both a Roth IRA and a traditional 401(k) plan. The Roth 401(k):

- Does not limit participation by income, unlike the Roth IRA.
- Allows participants to contribute on an after-tax basis, like the Roth IRA, up to the amounts permitted under a traditional 401(k).

Therefore, higher-income employees who are ineligible to open a Roth IRA can instead contribute to a Roth 401(k) at higher amounts than are permitted in a Roth IRA. In addition, although some plans permit employees to make after-tax contributions to 401(k) plans, earnings on those contributions are taxed when distributed. By contributing to a Roth 401(k) plan, employees can contribute on an after-tax basis without being taxed in the future.

While individuals often must pay small account fees if their Roth IRAs have small balances, in a Roth 401(k) plan, the plan or plan sponsor may pay plan administration fees. This allows participant contributions to grow without a reduction for administrative overhead costs (see *Practice Note, Paying Employee Benefit Plan Expenses* (<http://us.practicallaw.com/4-504-8434>)).

## ROTH 401(K) REQUIREMENTS

Contributions that a participant designates as "designated Roth contributions" to a Roth 401(k) account generally are treated the same as an elective deferral for purposes of IRC Section 401.

For an employer to offer a valid Roth 401(k) plan:



- The employer must also offer a traditional 401(k) plan. Designated Roth accounts cannot exist without an accompanying pre-tax elective deferral plan.
- Participants must be able to designate some or all of their elective deferrals as Roth 401(k) contributions (see *Treating Elective Deferrals as Roth 401(k) Contributions*).
- The employer must include designated Roth contributions in the employee's gross income (*IRC § 402A(a)(1)*).
- Roth contributions must be tracked and their records kept in a separate account, with any applicable earnings and losses allocated to that Roth account (see *Separate Accounting for Roth 401(k) Accounts*).

### TREATING ELECTIVE DEFERRALS AS ROTH 401(K) CONTRIBUTIONS

Participants must designate their contributions as Roth 401(k) contributions at the time of the cash or deferred election (*Treas. Reg. § 1.401(k)-1(f)(1)(i)*). Roth contributions are treated as elective deferrals under IRC Section 402(g)(3) and are subject to the same annual maximum limits as elective deferrals made to a traditional 401(k) (\$17,500 for 2014 for participants under 50 years old) (*IRC § 402A(a)(1), (c)(2)* and *Treas. Reg. § 1.401(k)-1(f)(4)*).

Because Roth contributions are treated as elective deferrals, the following rules apply:

- Participants may contribute to both a Roth and a traditional 401(k), but both contributions together are subject to the limits under IRC Section 402(g).
- Plans may allow participants aged 50 and over to make additional elective deferral contributions or "catch-up contributions." These participants may make catch-up contributions as Roth 401(k) contributions under the same restrictions as traditional 401(k) catch-up contributions (*IRC § 414(v)(1), (5)*). For 2014, participants may contribute up to \$5,500 over the annual contribution limit of \$17,500, up to a total of \$23,000.

In addition:

- Recharacterizations are not allowed. Once a participant has designated an elective deferral as a Roth 401(k) contribution, the contribution is irrevocably a Roth contribution (*Treas. Reg. § 1.401(k)-1(f)(1)(i)*).
- Participants must be allowed to change their contributions for future contributions at least once per year (*Treas. Reg. § 1.401(k)-1(f)(5)(i)*).
- Employees who become participants in a 401(k) plan through automatic enrollment may be automatically enrolled in a Roth 401(k) rather than a traditional 401(k) plan. Plan documents must specify whether contributions made for those participants will be designated Roth or pre-tax contributions. If the plan defaults to Roth contributions, employees are deemed to have irrevocably designated their contributions as Roth if they have not made an affirmative election (*Treas. Reg. § 1.401(k)-1(f)(5)(ii)*).

### EMPLOYER CONTRIBUTIONS

Employers may not make contributions to a designated Roth account. Any employer contributions, such as matching or profit-

sharing contributions, must be treated as pre-tax contributions and added to the participant's pre-tax account. However, special rules apply for in-plan rollovers to a Roth account (see *In-plan Rollovers*).

### NONDISCRIMINATION RULES

As with all deferred compensation plans qualified under the IRC for favorable tax treatment, Roth 401(k) plans may not discriminate in favor of highly compensated employees (HCEs) (see *Practice Note, Requirements for Qualified Retirement Plans: Nondiscrimination Rules* (<http://us.practicallaw.com/3-506-6895#a788432>)). Roth 401(k) plans are therefore subject to the same nondiscrimination tests as traditional 401(k) plans. For purposes of the Actual Deferral Percentage (ADP) test, Roth contributions are treated as elective deferrals (*Treas. Reg. § 1.401(k)-1(f)(4)(i)*). However, while Roth contributions are made on an after-tax basis, they are not included with traditional after-tax contributions and therefore are not generally subject to the Actual Contribution Percentage (ACP) test.

For an overview of the ADP and ACP tests, see *Practice Note, Safe Harbor 401(k) Plans: Overview and Planning Opportunities: Nondiscrimination Rules* (<http://us.practicallaw.com/9-501-1089#a851205>).

If a plan must reduce contributions by HCEs to meet the nondiscrimination requirements, the plan can either:

- Specify whether Roth contributions or pre-tax contributions are returned to the participant first.
- Authorize participants to elect which contributions are refunded on a participant-by-participant basis. If Roth contributions are refunded, only earnings on those Roth contributions will be taxed (*Treas. Reg. §§ 1.401(k)-2(b)(1)(i), (2)(vi)(C)* and *1.401(m)-2(b)(2)(vi)(C)*).

Finally, the Roth 401(k) contribution feature is itself a benefit, right or feature that is subject to the nondiscrimination rules. Plans may not discriminate in favor of HCEs when offering the Roth option (*Treas. Reg. § 1.401(k)-1(a)(4)(iv)(B)*).

### SEPARATE ACCOUNTING FOR ROTH 401(K) ACCOUNTS

Plan sponsors offering a Roth 401(k) option must maintain:

- Separate accounts for each participant's Roth 401(k) contributions and allocable earnings.
- Separate recordkeeping for each participant's Roth and non-Roth accounts.

(*IRC § 402A(b)(2)*.)

Roth 401(k) and traditional 401(k) accounts must be charged and credited with gains, losses and other credits and charges on a reasonable and consistent basis (*Treas. Reg. § 1.401(k)-1(f)(3)*). This rule prevents plan sponsors from allocating expenses to tax-deferred accounts to maximize the value of after-tax Roth accounts.

Although Roth contributions are elective deferrals, Roth 401(k) accounts and traditional 401(k) accounts are treated separately for:

- The *de minimis* distributions rule, under which plans may provide that accounts with a balance of \$200 or less may not be rolled over in a direct rollover (see *Treas. Reg. § 1.401(a)(31)-1(A-11)*).

- Automatic rollover rules for mandatory distributions under IRC Section 401(a)(31)(B) (*Treas. Reg. § 1.401(k)-1(f)(4)(ii)*). Under this rule, if a participant's account balance is between \$1,000 and \$5,000 and the participant does not affirmatively elect to receive a distribution in another manner permitted by the plan, the plan may roll over the involuntary distribution to an IRA established for the participant (see *IRC § 401(a)(31)(B)* and *Practice Note, Requirements for Qualified Retirement Plans: Basic Qualification Requirements* (<http://us.practicallaw.com/3-506-6895#a570836>)).
- Rules relating to the division of rollover distributions into separate plans (*Treas. Reg. §§ 1.401(k)-1(f)(4)(ii)* and *1.401(a)(31)-1(A-9 to A-11)*).

## DISTRIBUTIONS FROM ROTH 401(K) ACCOUNTS

As with a traditional 401(k) plan, participants may only receive distributions from their Roth 401(k) accounts on (if permitted under the plan's terms):

- Terminating employment.
- Death.
- Disability.
- Reaching age 59½.
- Determination of hardship.

In addition, unlike the Roth IRA, Roth 401(k) plans are subject to the IRC's minimum required distributions requirements during the participant's lifetime (see *Treas. Reg. § 1.401(k)-1(f)(4)*, *IRC § 401(a)(9)* and *Practice Note, Requirements for Qualified Retirement Plans: Basic Qualification Requirements* (<http://us.practicallaw.com/3-506-6895#a570836>)).

The payment of an annuity contract from a Roth 401(k) account is not considered a distribution. Only amounts paid from the annuity contract itself qualify as distributions (*Treas. Reg. § 1.402A-1(A-14)*). Distributions from Roth accounts are not aggregated with distributions from non-Roth accounts for the rules regarding annuity payments and the taxation of annuity payments under IRC Section 72.

### Qualified Distributions

Only "qualified distributions" from Roth 401(k) accounts are tax-free. Qualified distributions:

- Are made:
  - on or after the participant reaches age 59½;
  - on or after the participant's death; or
  - due to the participant's disability.
- Cannot be made within five years of the participant's first designated Roth contribution to that plan or a predecessor plan (see *Calculating the Five-year Participation Period*).

(*IRC § 402A(d)*.)

Qualified distributions to beneficiaries and alternate payees are also measured by the participant's age, death or disability status, unless the beneficiaries and alternate payees roll the distribution over to their own designated Roth accounts.

Unlike the Roth IRA, a distribution to finance the first-time purchase of a home is not a qualified distribution (*IRC § 402A(d)(2)(A)*).

## Calculating the Five-year Participation Period

Generally an employee's five-year participation period is determined separately for each plan. The five-year participation period begins to run from the first day of the first taxable year that the participant made a contribution to the particular Roth 401(k) account (*IRC § 402A(d)(2)(B)(i)* and *IRS Notice 2013-74(A-8)*). If the participant previously established another designated Roth account and rolls the funds over to that account:

- The five-year period begins to run from the date of the first contribution to the first designated Roth account.
- For a direct rollover made from one plan to another, the plan making the rollover must, within 30 days of the rollover, either:
  - report the first year of the five-year period and the portion of the distribution that is investment in the contract to the new plan; or
  - provide a statement that the distribution is qualified.
- For an indirect rollover, where the participant receives the distribution and has 60 days to roll it over, the plan making the rollover must, on request, provide the participant a statement that the distribution is qualified or report the portion of the distribution that is investment in the contract within 30 days of the request.

(*IRC § 402A(d)(2)(B)(ii)* and *Treas. Reg. § 1.402A-2(A-2)*.)

This is different from Roth IRAs, which begin the five-year period from the date of the first contribution made to **any** Roth IRA, not necessarily the one into which the participant rolls funds over. Therefore, if a participant rolls a distribution from a Roth 401(k) account to a Roth IRA, the period that the funds were in the Roth 401(k) account do not count towards the Roth IRA's five-year period.

Some contributions do not start the five-year period, including:

- Excess deferrals.
- Excess contributions that a plan distributes to comply with the ADP test (see *Nondiscrimination Rules and Practice Note, Safe Harbor 401(k) Plans: Overview and Planning Opportunities: Nondiscrimination Rules* (<http://us.practicallaw.com/9-501-1089#a851205>)).
- Contributions returned to a participant as a permissible withdrawal from an eligible automatic contribution arrangement (see *IRC § 414(w)*).

(*Treas. Reg. § 1.402A-1(A-4)(a)*.)

A reemployed veteran's designated Roth contributions are treated as made in the taxable year of qualified military service that the veteran designates as the year to which the contributions relate (*Treas. Reg. § 1.402A-1(A-4)(e)*).

### Treatment of Non-qualified Distributions

Non-qualified distributions include:

- Distributions of excess deferrals under IRC Section 402(g)(2).
- Distributions of excess contributions under IRC Section 401(k)(8).
- Distributions of excess aggregate contributions under IRC Section 401(m)(8).
- Income earned on these excess deferrals or contributions.

- Certain amounts not treated as eligible rollover distributions, including:
  - loans treated as deemed distributions; and
  - dividends on employer securities, as described in IRC Section 404(k).

(IRC § 402A(d)(2) and *Treas. Reg. § 1.402A-1(A-2), (A-11)*.)

Non-qualified distributions are partially included in the participant's gross income if there are earnings in the participant's account. Distributions are treated as coming pro rata from:

- Earnings.
- Tax-free contribution (also known as basis).

This is different from a Roth IRA, in which non-qualified distributions are treated as a tax-free return of basis up to the amount of the Roth IRA contributions. A 10% penalty for early withdrawal may apply to the part of the distribution that is includible in gross income unless an exception in IRC Section 72(t) applies (*Treas. Reg. § 1.402A-1(A-3)* and *IRS: Designated Roth Accounts - Distributions from Designated Roth Accounts*).

### Hardship Distributions

Hardship distributions are permitted under Roth 401(k) plans under similar rules as apply to traditional 401(k) plans (*Treas. Reg. § 1.401(k)-1(d)(3)*). The amount of contributions available for a hardship distribution are determined by the participant's total elective contributions, Roth and non-Roth, not including earnings on those accounts.

When distributed for hardship purposes, Roth contributions are treated as a pro rata return of basis and earnings. If a participant takes a hardship distribution out of a Roth 401(k) within five years of the first contribution, the participant is taxed on the earnings portion of the hardship payout (see *Calculating the Five-year Participation Period and Treatment of Non-qualified Distributions*). For more information on hardship distributions see, *Hardship Distribution Checklist* (<http://us.practicallaw.com/8-518-8776>).

### ROLLOVERS TO OTHER ROTH ACCOUNTS

Participants may roll a Roth 401(k) distribution over into another Roth account that accepts rollovers or into a Roth IRA account. However, Roth 401(k) distributions cannot be rolled over into a traditional 401(k) or a traditional IRA and a Roth IRA may not be rolled over into a Roth 401(k) account (*IRC § 402A(c)(3)* and *Treas. Reg. § 1.408A-10(A-5)*).

Plans may also permit in-plan rollovers from non-Roth accounts to Roth 401(k) accounts (see *In-plan Rollovers*).

### Rollover Methods

Distributions from a Roth 401(k) consist of basis (contributions that were taxed when made) and earnings, which will not be taxed if distributed as a qualified distribution. Distributions of both basis and earnings may be rolled over from a Roth 401(k) to a Roth IRA by either an indirect or direct rollover. However, the basis portion of a distribution may only be rolled over from a Roth 401(k) into another Roth account by a **direct** rollover (*Treas. Reg. §§ 1.401(k)-1(f)(4)(ii)* and *1.402A-1(A-5)(a)*).

Therefore, in an indirect rollover, the employee receiving the distribution can:

- Roll the entire amount, including both basis and earnings, over into a Roth IRA within 60 days (*Treas. Reg. § 1.402A-1(A-5)(a)*).
- Roll only the earnings portion of the distribution over to a Roth account within 60 days. In this case:
  - the recipient plan must notify the IRS that it has accepted the rollover contribution (see *Participant and Plan Level Reporting*);
  - the employee's period of participation under the distributing plan is not carried over to the recipient plan for purposes of the five-year participation period; and
  - the indirect rollover starts the five-year participation period under the recipient plan if the participant has not yet made designated Roth contributions to that plan.

(*Treas. Reg. § 1.402A-1(A-5)* and *Treas. Reg. § 1.402A-2(A-3)*.)

### Tax Treatment of Rollover Distributions

Because earnings on designated Roth contributions are pre-tax while the contributions to a Roth 401(k) have already been taxed, a participant receiving a non-qualified Roth 401(k) distribution is subject to tax on the earnings only, not the basis. If a participant receives a non-qualified distribution in an indirect rollover and only rolls over part of those funds, the portion rolled over is deemed to come first from earnings. This allows the participant to roll over only the portion of the distribution that would otherwise be taxable (*Treas. Reg. § 1.402A-1(A-5)(b)*).

In-plan rollovers from non-Roth accounts to Roth accounts are included in gross income (*IRC § 402A(c)(4)(A)(i)*). For distributions rolled over in 2010, this gross income is by default included ratably over two years, beginning in 2011 (*IRC § 402A(c)(4)(A)(iii)*).

When a participant rolls a Roth 401(k) distribution over into a Roth IRA:

- For a qualified distribution, the entire distribution is treated as basis in the Roth IRA. A subsequent distribution of this amount is treated as a tax-free return of basis regardless of whether the Roth IRA has been maintained for five years.
- For a non-qualified distribution, only the portion of the distribution that was basis in the Roth 401(k) is treated as basis in the Roth IRA. Earnings on the Roth 401(k) contributions are not treated as basis in the Roth IRA.

### TREATMENT OF EXCESS DEFERRALS

If a participant contributes too much to a Roth 401(k) plan in any one taxable year, over the limits set out in *IRC Section 402(g)*, the plan must distribute the excess deferrals. Plans must consider both the participant's Roth 401(k) and traditional 401(k) plan contributions to determine whether the participant has exceeded the limit for permitted elective deferrals that tax year (see *Treating Elective Deferrals as Roth 401(k) Contributions*).

Roth 401(k) contributions that are distributed as excess deferrals after the year of the contribution will not be taxed if they are distributed on or before April 15 of that year. Earnings attributable to the excess designated Roth contributions are taxed when distributed.

However, if the plan fails to distribute excess deferrals by April 15 of the year after the contribution, the Roth 401(k) contribution will be **double-taxed**, both at the time of contribution and at distribution. Earnings attributable to the excess designated Roth contributions are also taxable (*IRC § 402A(d)(3)* and *Treas. Reg. § 1.402(g)-1(e)(8) (iii), (iv)*). Participants may designate whether excess deferrals are to be reimbursed out of their pre-tax or Roth contributions (*Treas. Reg. § 1.402(g)-1(e)(2)(i)*).

### PARTICIPANT AND PLAN LEVEL REPORTING

In general, the same reporting requirements apply to Roth 401(k) plans as other plans. Plans must report contributions to the IRS as elective deferrals on the participant's W-2 and report any distributions made on Form 1099-R.

In accordance with IRS forms, if a portion of a Roth 401(k) distribution is includible in the participant's income and the participant rolls over any part of the distribution to another Roth account by an indirect rollover, the plan administrator of the recipient plan must notify the IRS that it has accepted the rollover contribution (*Treas. Reg. § 1.402A-2(A-3)*). However, a participant rolling over a distribution from a Roth 401(k) plan to a Roth IRA should keep track of the amount rolled over himself (see Form 8606).

### ADDITIONAL CONSIDERATIONS FOR ROTH 401(K) PLANS

Employers may choose to offer the following optional features in Roth 401(k) plans:

- Automatic enrollment.
- Employer matching to the accompanying pre-tax account.
- In-plan rollovers (see *In-plan Rollovers*).
- Plan loans. All of the participant's Roth and non-Roth accounts are combined when applying plan loan rules (*Treas. Reg. § 1.402A-1(A-12)*).

A participant who receives a qualified distribution of employer securities with a net unrealized appreciation has basis in the securities equal to their fair market value at the date of distribution. Only future appreciation is subject to tax at capital gains rates. Non-qualified distributions are subject to the regular net unrealized appreciation rules, but the Roth 401(k) account as a whole is treated as a separate contract (*Treas. Reg. § 1.402A-1(A-10)*).

Roth 401(k) contributions must be taken into account when applying plan rules for 401(k) and 401(m) safe harbor plans (see *Practice Note, Safe Harbor 401(k) Plans: Overview and Planning Opportunities* (<http://us.practicallaw.com/9-501-1089>)).

### ROTH 403(B) AND GOVERNMENTAL 457(B) PLANS

EGTRRA allowed the addition of a Roth feature to 403(b) plans and the Small Business Jobs Act of 2010 allowed governmental 457(b) plans to adopt a Roth feature as well. 403(b) plans are pre-tax retirement plans that can be offered to employees of educational organizations and non-profit organizations, including hospitals, museums, churches and research organizations. Governmental 457(b) plans are pre-tax retirement plans that can be offered to employees of state and local governments.

The rules governing Roth 401(k) plans generally apply to both Roth 403(b) plans and Roth governmental 457(b) plans, except the right to make Roth contributions to a 403(b) plan must be universally available to satisfy the universal availability requirement in IRC Section 403(b)(12) (*Treas. Reg. § 1.403(b)-3(c)* and IRS: Retirement Plans FAQs on Designated Roth Accounts).

In-plan rollovers are also available to both 403(b) and governmental 457(b) plans with a Roth feature. Although Roth 403(b) and 401(k) plans have been able to offer in-plan rollover options since September 27, 2010, governmental 457(b) plans with a Roth feature did not have this option until January 1, 2011 (see *In-plan Rollovers*).

### IN-PLAN ROLLOVERS

As of September 27, 2010, the Small Business Jobs Act of 2010 also permitted plan sponsors that already had Roth 401(k) plans to offer their participants an in-plan Roth conversion (*IRC § 402A(c)(4) (B)*). This feature allows participants to rollover their eligible non-Roth plan distributions to a Roth option within the same plan, so participants do not have to remove funds from their employer's plan.

Participants, their surviving spouse beneficiaries or alternate payees who are spouses or former spouses are eligible to use the in-plan rollover option.

The deadline for plan sponsors to adopt an amendment offering in-plan Roth rollovers is the last day of the plan year in which the amendment is effective. For sample in-plan Roth rollover language, see *Standard Clause, Plan Language, In-plan Roth Rollover Contributions for 401(k) Plans* (<http://us.practicallaw.com/7-513-1403>).

### REQUIREMENTS FOR IN-PLAN ROLLOVERS

Plan sponsors must have a pre-existing designated Roth account option available to offer an in-plan rollover. Plan sponsors also cannot create a Roth account solely to accept rollover contributions. Any Roth account must accept designated Roth elective deferrals as well as rollover contributions.

Prior to 2013, the amount rolled over was required to be eligible for distribution to the participant under the plan's terms and as allowed by the IRC. This requirement was changed by the American Taxpayer Relief Act of 2012 by adding IRC Section 402A(c)(4)(E). Effective after December 31, 2012, the amount rolled over is not required to be eligible for distribution to the participant. However, the amount rolled over and applicable earnings remain subject to any distribution restrictions applicable to the amount before the in-plan *Roth rollover* (*IRS Notice 2013-74(A-3)*).

Prior to 2013, the plan sponsor was permitted to amend the plan to add distribution options beyond those currently offered to take advantage of the in-plan Roth rollover, for example, by allowing in-service distributions for participants over age 59½. As a result of the changes made by the American Taxpayer Relief Act, such an amendment is no longer required for plan participants to effectuate an in-plan Roth rollover.

Unlike Roth IRAs, rollovers to a designated Roth account from a traditional pre-tax account are irreversible when done (*IRS Notice 2010-84(A-6)*).

## TAX TREATMENT OF ROLLED OVER AMOUNTS

Because an in-plan Roth conversion allows participants to roll over funds from a pre-tax account to an after-tax Roth account, the taxable amount of any in-plan rollover distribution must be included in the participant's gross income. For rollovers completed in 2010, participants by default must report half of the recognizable income in 2010 and half in 2012 (this does not apply to government 457(b) plans with a Roth option because those plans were not available until 2011). Participants subject to this rule may elect to report all of the taxable income in 2010 instead (*IRC § 402A(c)(4)(A)*).

The IRS does not impose a 10% early withdrawal penalty on funds rolled over from a pre-tax account to a designated Roth account. However, if a participant withdraws any part of the in-plan rollover from the designated Roth account within five years of the rollover, the participant's withdrawal is subject to the 10% penalty on early distributions under IRC Section 72(t) unless:

- The distribution is allocable to a nontaxable portion of the in-plan rollover.
- An exception applies.

Each rolled over amount has its own five-year period. If, for example, a participant rolls over \$10,000 in year one and \$5,000 in year six, the participant will not be penalized for withdrawing up to \$10,000 in year six (*IRC §§ 402A(c)(4)(D), 408A(d)(3)(F)* and *IRS Notice 2010-84(A-12)*.)

This rule does not apply to a distribution rolled over to another designated Roth account or Roth IRA, but it does apply to any subsequent distributions made from those Roth accounts within five years (*IRS Notice 2010-84(A-12)*).

## ADDITIONAL FEATURES OF IN-PLAN ROLLOVERS

Participants may transfer distributions that are eligible rollover distributions of distributable amounts in a:

- Direct rollover by transfer or non-Roth amounts to a Roth account.
- Indirect rollover by distribution of funds to the individual who then rolls over the funds into a Roth account in the plan within 60 days.

However, in-plan rollovers of nondistributable amounts may only be accomplished by a direct rollover (Roth rollover (*IRS Notice 2013-74(A-7)*))

Distributions transferred in a direct rollover to a designated Roth account are not treated as distributions for the following purposes:

- Plan loans transferred in an in-plan direct rollover are not treated as new loans.
- Spousal consent is not required before rolling the funds over.
- The transferred amount is counted when determining whether a participant's accrued benefits exceed \$5,000. The rollover does not trigger a notice of the participant's right to defer receiving the distribution.
- A participant that had a distribution right before the rollover retains that right after the rollover (for example, the right to an immediate distribution of the rolled over amount).

(*IRS Notice 2010-84(A-3)*.)

Unlike direct rollovers, indirect rollovers are subject to the 20% mandatory federal income tax withholding rules under IRC Section 3405(c). If a participant takes an indirect rollover of an eligible rollover distribution from the plan's non-Roth account, the 20% mandatory withholding rules apply even if the participant rolls the full amount over to a designated Roth account within 60 days.

For more information on in-plan Roth rollovers, see *IRS: Retirement Plans FAQs on Designated Roth Accounts*.

Subject to the nondiscrimination requirements (see *Nondiscrimination Rules*), plans are also permitted to restrict:

- The type of contributions eligible for in-plan Roth rollovers.
- The frequency of in-plan Roth rollovers.

(*IRS Notice 2013-74(A-6)*).

## IMPLEMENTING ROTH 401(K) PROGRAMS

Plan sponsors must take the following steps to implement a Roth 401(k) or other designated Roth account:

- If recordkeeping is outsourced to another service provider, communicate with the service provider about its ability to keep separate records for Roth contributions. Plan sponsors may also need to modify their own recordkeeping and payroll systems to accommodate Roth 401(k) requirements.
- Determine which Roth 401(k) features to implement and when to implement those features.
- When the Roth 401(k) feature is available, send participants new required forms, including updated summary plan descriptions and election forms.
- Submit the plan for an IRS determination letter when the process is open for designated Roth features (which depends on the type of plan and its filing cycle).
- Amend plan documents to account for:
  - separate accounts for Roth 401(k) contributions;
  - the choice of both pre-tax and designated Roth elective deferrals in the plan; and
  - the requirement that only Roth elective deferrals may be contributed to the Roth 401(k) account.

In general, plans must be amended by the end of the plan year in which the Roth accounts are effective (*Rev. Proc. 2007-44 § 5.02(2)*). However, a plan amendment for in-plan Roth rollovers of nondistributable amounts is due by the later of:

- The last day of the first plan year in which the amendment is effective.
- December 31, 2014, provided the amendment is effective as of the date the plan first operates in accordance with the amendment. Special rules apply to safe harbor plans.

(*IRS Notice 2013-74(A-5)*).

Plan sponsors should also:

- Decide how Roth 401(k) distributions fit into the plan's distribution hierarchies. For example, do participant distributions come first from pre-tax deferrals, then Roth 401(k) contributions and then rollover accounts?

- Determine whether the additional administrative issues and potential expenses involved in setting up a designated Roth account are worth the added value to the plan's employees by having the Roth option.
- Consider likely questions from participants. If a plan permits Roth contributions, participants are likely to ask whether they should elect to make pre-tax or Roth elective deferrals. Providing investment advice on this issue may create new fiduciary exposure for plan sponsors and administrators.

The IRS provides a Sample Amendment for Roth Elective Deferrals on its website, as well as an updated Listing of Required Modifications and Information Package for plans to satisfy IRC requirements, which includes in-plan rollover language (this language has not been updated for nondistributable amounts). Plan sponsors should review both before drafting their own plan amendments adopting designated Roth accounts.

For sample language to add a Roth 401(k) feature to a 401(k) plan, see *Standard Clause, Plan Language, Roth 401(k) Contributions* (<http://us.practicallaw.com/1-525-1931>).

For sample in-plan rollover language, see *Standard Clause, Plan Language, In-plan Roth Rollover Contributions for 401(k) Plans* (<http://us.practicallaw.com/7-513-1403>).

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