

Employee Benefits Corner

By Elizabeth Thomas Dold and David N. Levine

IRS Guidance Gives In-Plan Roth Rollovers New Life

In January 2013, Congress passed, and the President signed into law, H.R. 8, the American Taxpayer Relief Act of 2012,¹ which extended the existing in-plan Roth rollover rules to amounts not otherwise distributable under the plan. Recent Notice 2013-74² clarifies a number of open issues regarding the new (and existing) rollover feature, building on Notice 2010-84,³ which provided the initial ground rules in this area. Now that the expanded IRS guidance has been issued, plan sponsors should take another look at this feature—which 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 current taxable event, but the subsequent earnings thereon may avoid federal income taxation altogether. This column briefly reviews the history of the Roth program, summarizes the new guidance in this area, reviews the comprehensive rules applicable to all in-plan Roth rollovers, and provides action steps for plan sponsors to take a fresh look at this optional plan design feature.



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A. Summary of Roth History

Following the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), a participant was permitted to make salary deferral contributions under a 401(k) or 403(b) plan as after-tax Roth contributions to a designated Roth account. This provision began in 2006, and all participants are eligible to make these deferrals (there is no “adjusted

Chart 1.

Notice 2013-74	Clarifying Provision	Original IRRs — Eligible Rollover Distributions	New IRRs — Not Otherwise distributable
Q&A-1	Application of Notice 2010-84 (the original set of guidance for IRRs)	Applies.	Same, other than parts of Q&A-1 (no indirect rollover), Q&A-2 (distribution rules do not need to be met), and Q&A-5 (no 402(f) notice).
Q&A-2	Eligible Amounts	Vested contributions (and earnings thereon) that are “currently distributable” and would be treated as an eligible rollover distribution if distributed (including amounts only eligible for in-plan rollover), and the plan so provides.	Vested contributions (and earnings thereon) that are not “currently distributable,” and the plan so provides. This includes elective deferrals, match, profit sharing, non-elective contributions, QNECs, and QMACs.
Q&A-3	Distribution Restrictions	None.	Yes – same as original source.
Q&A-4	Income Tax Withholding	Voluntary withholding (optional).	Prohibited.
Q&A-5	Timing of Plan Amendment	Discretionary amendment – adopt by plan year-end.	Additional transition relief depending on type of plan involved.
Q&A-6	Plan Restriction on Type and Frequency of Rollover	Yes (subject to BRF testing).	Same.
Q&A-7	Anti-Cutback Issue	N/A	Same (but still need to track balances for distribution restrictions).
Q&A-8	Qualified Distribution	Tax-free distribution.	Same.
Q&A-9	Net Unrealized Appreciation (NUA) Treatment	Treated as a distribution for determining eligibility for NUA treatment.	Same.
Q&A-10	Treatment for Top-Heavy Status	Count as “related rollover”.	Same.
Q&A-11	Excess Amount To Be Distributed (and no other Plan sources)	Distribute from Roth account.	Same.

gross income” limit on these contributions, unlike contributions to a Roth IRA). However, these contributions are subject to an annual limit under Code Sec. 402(g), which is \$17,500 for 2014 (when combined with pre-tax deferrals). Moreover, the interest earned under these Roth accounts is never taxed, provided that the distribution constitutes a “qualified distribution” from the plan. In general, the contributions must be held in the account for five years and the participant must have reached age 59 1/2, or died or become disabled (or rolled over to a Roth IRA or another designated Roth account). But importantly, employer contributions (e.g., matching and profit sharing contributions) were not able to be converted to a designated Roth account inside the qualified plan.

Effective on or after September 28, 2010, section 2112 of the Small Business Jobs and Credit Act of 2010⁴ (the “Act”) added a new design feature to 401(k) and 403(b) plans (and effective January 1, 2011, governmental 457(b) plans) to permit a conversion of certain non-Roth amounts to be rolled over to a designated Roth account within the same plan—called in-plan Roth rollovers (IRRs). The

IRS guidance issued in Notice 2010-84 facilitated implementation of this provision, and provided additional favorable tax treatment for 2010 conversions only—permitting a participant to defer the resulting income taxes in two equal installments in 2011 and 2012.

Effective on or after January 1, 2013, the American Taxpayer Relief Act of 2012, extended the existing in-plan Roth rollover rules to amounts not otherwise distributable under the plan.

B. Summary of New Guidance—Notice 2013-74

The IRS issued Notice 2013-74 that provides the ground rules for implementing in-plan Roth rollovers, which clarifies, in Q&A format, both the rules for existing IRRs that have been available since 2010 (as described in Notice 2010-84) and the expanded IRRs that have been available since January 2013 following the enactment of The American Taxpayer Relief Act of 2012. Chart 1 summarizes each of the Q&As in turn, along with the impact on both types of in-plan Roth rollovers.

C. Summary of In-Plan Roth Rollover Rules

Set forth below is a summary of the applicable rules for in-plan Roth rollovers. The same rules generally apply with respect to both distributable and non-distributable amounts, as noted above. But to the extent the rules vary, we indicated that below in the heading (“varies”).

- **Plans Covered**—The in-plan Roth rollover rules apply to plans that permit Roth elective deferrals under a 401(k) plan, 403(b) plan, or governmental 457(b) plan. Therefore, it is not permissible to establish a plan that only accepts IRRs, but does not otherwise provide for on-going Roth deferrals. Moreover, money purchase plans and defined benefit plans cannot accept IRRs.
- **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. Although commentators asked that nonspouse beneficiaries be eligible to make IRRs, the guidance does not appear to extend these rules to such beneficiaries.
- **Amounts Eligible for Conversion (varies)**—The in-plan Roth rollover provisions apply 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, and (2) vested contributions (and earnings thereon) that are *not* “currently distributable,” if the plan so provides.

The Notice clarifies that the expanded nondistributable election is limited to vested amounts, and includes the following types of contributions:

- Pre-tax deferrals (and applicable earnings) under a Code Sec. 401(k) plan (including the federal government’s Thrift Savings Plan)
- Pre-tax deferrals (and applicable earnings) under a Code Sec. 403(b) plan
- Pre-tax deferrals (and applicable earnings) under a governmental Code Sec. 457(b) plan
- Matching, profit sharing or other nonelective employer contributions (and applicable earnings) under a 401(k), 403(b), or governmental 457(b) plan
- Qualified nonelective contributions (QNECs) and qualified matching contributions (QMACs) (and applicable earnings)

For example, an active employee who has not yet reached age 59 1/2 can now convert his pre-tax

deferrals, even though these amounts would not be currently distributable.

Notably, the Notice 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. Therefore, the plan amendment may limit the timing of the rollover election (e.g., once per year), and can also limit the types of contributions that are eligible for Roth conversion (e.g., only 401(k) deferrals), which may serve to help ease plan administration complexities.

- **Direct or Indirect Rollovers (varies)**—The in-plan Roth rollover for currently distributable amounts is available *via* a direct or indirect (60-day) rollover. However, the expanded nondistributable amounts election is limited to a direct rollover only (*i.e.*, indirect (or “60-day”) rollovers will not be permitted). Moreover, for nondistributable amounts, the 402(f) (rollover) notice does not need to reflect these rules nor be provided to the participant, as the amounts are not otherwise eligible rollover distributions.
- **Allowable In-Service Distributions (varies)**—For currently available distributions, no withdrawal restrictions are imposed on the converted amounts. However, for nondistributable amounts, the same withdrawal restrictions that applied prior to the conversion continue to apply after the conversion. For example, pre-tax 401(k) deferrals that are converted cannot be distributed until the participant has reached age 59 1/2 or has satisfied another distributable event set forth in Code Sec. 401(k)(2)(B) (e.g., hardship). Importantly, regardless of the type of conversion, no spousal consent is required, nor is a notice to defer required to be provided. However, the conversion does generally require that the participant forego any favorable “net unrealized appreciation” (NUA) treatment of employer stock.
- **Recordkeeping (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 non-distributable amounts. Moreover, care should be taken to ensure that the converted funds are invested in accordance with the participant’s intent.
- **Plan Amendment (varies by plan type)**—An in-plan Roth 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 December 31, 2014, to adopt amendments for in-plan rollovers of nondistributable amounts offered in 2013. For safe harbor 401(k) plans, plan sponsors have until December 31, 2014, to make 2013 or 2014 mid-year changes to provide in-plan Roth rollovers for nondistributable amounts. Similarly, Code Sec. 403(b) plan sponsors have until the last day of the plan year in which the provision is effective, or end of the remedial amendment period, whichever is later. This plan 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.

- **Qualified Distribution**—The in-plan Roth rollover feature is attractive because it has the potential of future earnings avoiding federal income taxation altogether, provided that the later distribution is a “qualified distribution.” A qualified distribution is:
 - made after a five-year period (generally beginning with the first tax 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 the first day of the first tax 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 (1) death, (2) disability, or (3) after a participant reaches age 59 1/2.
- **10-Percent Tax Recapture**—The 10-percent early withdrawal tax does not apply to an in-plan Roth rollover. However, 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 had not yet reached age 59 1/2 (or does not meet another exception to the 10-percent early distribution tax at the time of such later distribution), the distribution is 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). Therefore, the participant should be careful regarding the timing of the election and the investment returns, and understand the impact of his or her taxes.
- **Anti-Cutback Issue**—The discontinuation of the in-plan Roth rollover feature does not violate the anti-cutback provision of Code Sec. 411(d) (6). However, the timing of an amendment to eliminate the feature is subject to the nondiscrimination requirements under Reg. §1.401(a)(4)-5. Therefore, it should not, for example, be added so that HCEs can take advantage of the feature, and then eliminated after the officers have all made their elections.
- **Required Minimum Distribution Rules**—The in-plan rollover does not impact the required minimum distribution rules under Code Sec. 401(a)(9). Specifically, 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).
- **Reporting and Withholding (varies)**—In-plan Roth rollovers for currently distributable amounts are subject to voluntary withholding. However, no federal income tax can be withheld from nondistributable converted amounts. The fair market value of the converted funds will be reported on the current year Form 1099-R 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 (n/a 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).

D. Next Steps

The following action steps should be considered by plan sponsors with Roth designated accounts.

1. **Review Scope of Feature in Plan Document.** Consider the current implementation of this optional feature, and whether there is interest in extending the provision to more participants. Review with the Plan’s recordkeeper the ability to add or modify this provision, and the costs associated with maintenance of the feature (including the special Form 1099-R reporting obligations).
2. **Modify Election Forms and Participant Communications.** Update the Summary Plan Description (SPD)/Summary of Material Modifications (SMM) to reflect the provision, along with safe harbor notices (if applicable). Adopt/modify election forms for participants to elect the feature.

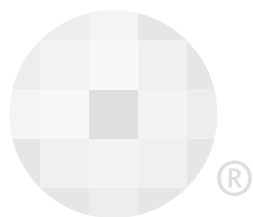
3. **Draft Plan Amendment.** The amendment should reflect the implementation decisions regarding the provision—including any restrictions on the timing of the election, the sources of contributions eligible, the impact on plan loans, and distribution ordering rules. The amendment must generally be adopted by the end of the plan year that it is added, with special transition relief

for mid-year charges to a safe harbor plan for 2013–2014.

ENDNOTES

- ¹ American Taxpayer Relief Act of 2012 (P.L. 112-240).
- ² Notice 2013-74, IRB 2013-52, Dec. 11, 2013.
- ³ Notice 2010-84, IRB 2010-51, Nov. 29, 2010.
- ⁴ H.R. 5297.

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