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PENSION ANALYST

Important information – Plan design

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# IRS provides guidance on expanded in-plan Roth rollover feature

## Who's affected

This information applies to sponsors of and participants in 401(k) plans, 403(b) plans and governmental section 457(b) plans.

## Background and summary

In late 2010, the Small Business Jobs Act of 2010 (SBJA) introduced a new plan design option for 401(k), 403(b) and governmental 457(b) plans that accept designated Roth contributions. This option allowed participants to convert otherwise distributable non-Roth account balances to Roth amounts via in-plan Roth rollovers.

On January 2, 2013, President Obama signed into law the American Taxpayer Relief Act of 2012 (ATRA), which included an expansion of the in-plan Roth rollover feature to also allow the conversion of otherwise non-distributable non-Roth account balances to Roth amounts. This option first became available effective January 1, 2013. However, the broad statutory provisions gave rise to numerous implementation issues and questions, which made it nearly impossible for service providers to offer the design or plan sponsors to adopt it. Finally, in mid-December 2013, the IRS provided administrative guidance by publishing Notice 2013-74. This notice addressed concerns such as:

- Types of contributions and non-distributable amounts eligible for rollover;
- Types of rollovers permitted;
- Participant notification requirements;
- Application of protected benefit rules to the amounts rolled over;
- Federal tax withholding requirements;
- Plan amendment timing requirements; and
- Acceptable limitations on all types of in-plan Roth rollovers.

## Action and next steps

When Notice 2013-74 was released, it was too late for most plan sponsors to consider adopting this design for 2013. As a result, many plan sponsors turned their attention to possible implementation in 2014. Plan sponsors that are interested in adopting this expanded in-plan Roth rollover option should review this publication carefully to become familiar with the special rules and additional considerations related to this design. In addition to contacting their Prudential Retirement representatives with questions about these provisions, plan sponsors should discuss any potential plan design changes with their legal counsel, as well as confirming that their recordkeeping service provider can administer the provision..

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## Original in-plan Roth rollover design

Under the original in-plan Roth rollover provision, sponsors of plans that allowed participants to make ongoing designated Roth contributions could also allow participants to convert non-Roth account balances that are otherwise eligible for distribution to Roth funds, via an in-plan rollover. Where a plan imposed stricter distribution restrictions than required by law, those provisions could be amended to allow distributions solely for the purpose of making in-plan Roth rollovers. Amounts are eligible for rollover under this original design only if they are considered “eligible rollover distributions.” Rollovers may be made either directly (where the funds do not actually leave the plan) or through a 60-day indirect rollover. Naturally, the pre-tax amounts converted are subject to federal income tax in the year in which the distribution is made, regardless of when the final rollover occurs. However, in-plan Roth rollover amounts are not subject to the annual deferral limit that applies to pre-tax deferrals and ongoing designated Roth contributions.

IRS Notice 2010-84 then clarified that all in-plan Roth rollover transactions are subject to the section 402(f) notice requirements. However, a direct in-plan Roth rollover is not treated as a true distribution for purposes of the right to defer distribution notice or the need for spousal consent, if applicable. But since direct rollovers do not require spousal consent, they retain all of the protected benefits that applied to the original contribution source. On the other hand, indirect rollovers begin with actual distributions from the plan and then return to the plan as essentially new money that is subject only to the restrictions imposed by the in-plan Roth rollover source.

With respect to taxation, the IRS confirmed that direct in-plan Roth rollovers are not subject to mandatory 20% withholding but participants may elect voluntary withholding. However, since indirect rollovers begin as true plan distributions, they are subject to that mandatory withholding. In addition, in-plan Roth rollovers are not subject to the 10% early distribution penalty tax at the time of conversion. However, if that tax would otherwise apply, a five-year recapture period is imposed. If the in-plan Roth rollover amounts are distributed before that period expires, the penalty tax is then applied. If multiple rollovers are made over the span of multiple years, separate recapture periods apply to each year’s rollovers.  These rollovers are also considered distributions for purposes of net unrealized appreciation (NUA).

## Expanded in-plan Roth rollover design

Under the expanded provision, non-distributable amounts may also be converted to Roth through an in-plan rollover. In Notice 2013-74, the IRS elaborated on the basic requirements as follows:

- As with the original design, these rollovers may only be offered under plans that allow ongoing designated Roth contributions. Of course, a plan may be amended to simultaneously allow ongoing designated Roth contributions and in-plan Roth rollovers, on a prospective basis.

- Only vested non-distributable amounts may be rolled over. As a result, the rollover of amounts from a fully vested contribution source could be relatively simple. However, the rollover of vested amounts from a partially vested source would result in the application of the special vesting formula that applies when distributions are made from such a source.

- Non-distributable amounts may only be directly rolled over; 60-day indirect rollovers are not allowed.

- Since these amounts are not distributable, neither the section 402(f) notice requirements nor the right to defer distribution notice requirement apply.

- Also, since these amounts are not distributable, all amounts converted and earnings on those amounts remain subject to the protected benefits and benefit restrictions that applied to the original contribution source.

- Federal tax withholding does not apply to conversions of non-distributable amounts and federal taxes cannot be voluntarily withheld from these rollover amounts. As a result, participants will have to look to other resources (e.g., savings accounts) to satisfy this tax liability, including the need to pay estimated taxes, if applicable.

- The five-year recapture rule also applies to rollovers of non-distributable amounts.

## Additional guidance applies to all types of in-plan Roth rollovers

The IRS also used Notice 2013-74 to provide guidance regarding all types of in-plan Roth rollovers, including the original design. For example:

- Plans may limit the types of contributions eligible for in-plan rollover, subject to nondiscrimination requirements.

- Plans may limit the frequency of in-plan rollovers (for example, to once per year).

- The ability to make an in-plan Roth rollover is not itself a protected benefit. As a result, a plan sponsor could adopt an in-plan rollover provision, administer that provision for a couple of years, and then decide to eliminate it (perhaps due to low usage or administrative complexity). However, such actions are still subject to the nondiscriminatory availability rules.

- If an in-plan Roth rollover of any type is the first contribution made to an employee’s designated Roth account, the five-year participation clock for determining if a later distribution is a non-taxable qualified distribution starts on the first day of the tax year in which that rollover was made. This five-year period is separate and distinct from the five-year recapture period discussed earlier.

- If an employee makes an in-plan rollover of his entire account balance and is later determined to have an excess deferral, excess contribution or excess aggregate contribution, then the excess must be distributed (plus allocable earnings) from that Roth account even if the amount was an otherwise non-distributable amount at the time of the in-plan Roth rollover.

## Careful consideration and evaluation is required

Due to the significant administrative complexity that may result, plan sponsors should carefully consider the adoption of the expanded in-plan Roth rollover feature and evaluate the potential costs and benefits to the plan and participants.

A primary concern for plan sponsors should be any source/fund limits imposed by the plan’s recordkeeping system. Since rollovers of non-distributable amount require the preservation of protected benefits and payment restrictions, all contribution sources available for these rollovers will have to be duplicated, at a minimum. To track the five-year recapture period, it may be necessary to create new sources annually. This would be in addition to any duplicate sources created to track direct in-plan Roth rollovers of distributable amounts. Plans that have had significant merger activity may have a limited number of additional sources available for use. In addition, plan sponsors that anticipate future merger activity may need to make sure that available source/fund combinations are not used up by in-plan Roth rollover sources. Plan sponsors should also consider how a proliferation of source/fund combinations could complicate reporting on participant statements.

Another plan design consideration is whether to allow the in-plan Roth rollover of partially vested contributions or to limit these rollovers to contributions that are 100% vested. If partially vested contributions are rolled over, the remaining non-vested account balance is subject to a special vesting formula.

While standard distribution notices are not required prior to the origination of an in-plan Roth rollover of non-distributable amounts, plans sponsors should consider supplying a special notice that explains important points such as the fact that an in-plan Roth rollover is irreversible, unlike a Roth IRA conversion. In addition, since these amounts are not distributable, federal income tax cannot be withheld by the plan and participants will need to satisfy their additional tax liability through the use of other personal resources, and may need to pay estimated taxes. The IRS has not indicated that it intends to provide sample language or a safe harbor notice to assist plan sponsors with these communications.

## Plan amendments

**For non-Safe Harbor 401(k) plans**

If a plan sponsor chooses to offer the expanded in-plan Roth rollover feature, it must amend its plan document accordingly. Typically, this type of discretionary amendment must be adopted by the end of the plan year in which it is effective. Since the IRS did not provide guidance for implementing this feature until the end of the 2013 calendar year, it is providing an extended amendment deadline that is the later of the last day of the first plan year in which the amendment is effective, or December 31, 2014, provided the amendment is effective as of the date the plan first operates in accordance with the amendment.

**For Safe Harbor 401(k) plans**

In general, Safe Harbor 401(k) plans (including Qualified Automatic Contribution Arrangements, or “QACAs”) cannot be amended mid-plan year. However, the IRS has provided a temporary period during which sponsors of Safe Harbor Plans make a mid-year change to provide for in-plan Roth rollovers of otherwise non-distributable amounts during 2013 or 2014, as long as the amendment is adopted by December 31, 2014.

**For 403(b) plans**

Plan amendments to permit in-plan Roth rollovers of non-distributable amounts must be adopted on or before the last day of the still-undetermined remedial amendment period for 403(b) plans or, if later, the last day of the first plan year in which the amendment is effective, provided the amendment is effective as of the date the plan first operates in accordance with the amendment.
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**For governmental section 457(b) plans**

Plan amendments to permit expanded in-plan Roth rollovers must be adopted by the later of the last day of the plan year in which the amendment is effective, or December 31, 2014, provided the amendment is effective as of the date the plan first operates in accordance with the amendment.
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**Additional application of extended amendment deadlines**

All of the extended amendment deadlines described above also apply to related amendments to:

- Permit designated Roth contributions (the baseline for being able to offer in-plan Roth rollovers of any type);
- Accept rollover contributions from outside of the plan into designated Roth accounts; and
- Allow in-plan Roth rollovers of some or all otherwise distributable amounts.

## Participant notification

There is currently no requirement to provide participants of advance notice of a plan’s addition of any type of in-plan Roth rollover feature. However, to comply with the qualified plan nondiscriminatory availability rules, sponsors of 401(k) plans that add this option will need to notify participants of its availability in sufficient time to allow them to take action if they so desire, as will sponsors of 403(b) plans that offer in-plan Roth rollovers of contributions other than elective deferral contributions.

After the fact, sponsors of plans that are subject to ERISA (e.g., 401(k) and 403(b) plans) will need to furnish participants and beneficiaries with either updated summary plan descriptions (SPDs) or summaries of material modifications (SMMs) that describe the in-plan Roth rollover option. The deadline for distributing an SMM is 210 days after the close of the plan year in which the amendment is adopted.

## Support from Prudential Retirement

Since 2010, Prudential Retirement has offered the original in-plan Roth rollover feature as a plan design option to sponsors of 401(k), 403(b) and governmental section 457(b) plans. Over a four-year period, relatively few plan sponsors have adopted this provision, and only 21% of the plans that have added an in-plan Roth rollover source have actually seen it used by plan participants. On average, fewer than 62 in-plan Roth rollovers have occurred per year over that same period. Nevertheless, Prudential will continue to offer this feature as a standard plan design option.

Given the complexities of administering the expanded option, Prudential would caution plan sponsors to carefully consider their current plan design, potential plan design changes (e.g., potential mergers), and actual participant use of the original in-plan Roth rollover option if it has been made available under the plan before deciding to pursue the addition of in-plan Roth rollovers of non-distributable amounts. In some cases, additional funds may be made available for rollover under the original design by modifying withdrawal restrictions solely for the purpose of allowing in-plan rollovers. Plan sponsors that would like additional information about this plan design option should contact their Prudential representative to discuss the feasibility of incorporating it into their plans.

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