Roth Elective Deferrals in a 401(k) Plan

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The Roth employee deferral option has been available for many years and the 2006 Pension Protection Act (PPA) made the option permanent. Before an employer decides to offer Roth deferrals in their 401(k) or 403(b) plan, careful consideration should be given to what is needed to properly administer the participant accounts.

BASIC RULES

Payroll withholding is treated just like other elective deferrals in that it is:

a) Part of the regular $18,000 limit (in 2017) for elective deferrals (plus an additional $6,000 in 2017 for participants who are age 50 by the end of the year).
b) Part of the overall $54,000 limit (indexed) on total annual additions (not counting catch-up contributions).
c) Counted in the usual 401(k) nondiscrimination tests.
d) Only to be withdrawn from the plan at 59 ½, termination of employment, or for a financial hardship.

The payroll withholding election irrevocably designates the contribution as a Roth contribution. This means the contribution is subject to regular wage withholding rules; and the account, like other participant contributions, is non-forfeitable at all times.

Unlike the Roth IRA, there is no income cap on who can contribute to a Roth 401(k) account. If the Roth 401(k) is an option inside the plan, then any participant may utilize it.

Distributions from a Roth account can be rolled to a Roth IRA, or to another plan that permits Roth accounts.

The same age 70 ½ minimum distribution rules applicable to pre-tax contributions also apply to Roth elective deferrals. (This is an area where the Roth deferral account differs from the Roth IRA, which is NOT subject to the 70 ½ minimum distributions.) However, the minimum distribution requirement can be avoided by rolling the Roth deferral account to a Roth IRA prior to 70 ½.

If a Highly Compensated Employee (HCE) must have dollars refunded to him in order to pass the 401(k) nondiscrimination test, the plan *may* allow him to designate whether such a distribution comes from pre-tax dollars or Roth 401(k) dollars, if he had contributed both. (It would also be acceptable for the plan to simply state how any refunds are allocated between the two sources – e.g., Roth first; proportionately; Roth last; etc.).

If a participant chooses to make nondeductible Roth contributions, any employer match would still be deductible to the *employer* and tax deferred to the employee (but limited to all of the existing rules on matching employer contributions).

As long as the Roth 401(k) dollars (and investment gains) are distributed after age 59 ½, total disability, or death, taxation will not apply provided the distribution occurs at least five years after the year of the first Roth deposit. If the distribution occurs prior to the end of the five-year period, the deferrals made by the participant (basis) will still be tax free but the investment gains will be taxed.

PLANNING ISSUES

Who should make Roth 401(k) contributions?

- Employees who believe they will experience a higher marginal tax rate after retirement.
- Possibly young employees who will get many years of tax-free compounding.
- Employees who want the opportunity to "hedge" their retirement savings by accumulating *both* tax deferred *and* tax free dollars because they are unsure of future tax rates.
- Higher paid employees whose income levels preclude them from contributing to Roth *IRAs*.

How does a plan implement Roth elective deferrals?

- Update elective deferral forms, allowing the employee to indicate if his elective deferral is pre-tax or Roth;
- Change the payroll system to allow both types of elective deferrals;
- Amend the plan document to permit Roth deferrals. Decide whether in-service withdrawals and loans will be allowed from the Roth source;
- Update the Summary Plan Description given to employees;
- Update the plan's recordkeeping system by adding Roth elective deferrals as an option and begin accounting for both the date of the first Roth deposit and the cumulative basis in the account; and
- Update distribution forms.

RELATED INFORMATION

The five-year tax period begins on the first day of the *employee's* taxable year for which he makes Roth contributions to the plan and ends at the *completion* of five consecutive taxable years. The year of the Roth contribution is reported on the Form 1099R issued after a distribution.

In order to preserve the basis and five-year tax period on a rollover, Roth deferral accounts should be rolled over as a direct trust-to-trust transfer, not as an indirect transfer.

For any partial distribution from a Roth deferral account that is not a "qualified distribution", a pro rata piece of the distribution is deemed to be a distribution of dollars not already taxed.

A defaulted loan that is treated as a deemed distribution is not a qualified distribution, even if it occurs after age 59 1/2 and completion of the five-year tax period.

For distributions from Roth deferral accounts that are not qualified distributions, the amount subject to income tax (i.e., investment gains) is also generally subject to the 10% early withdrawal penalty.

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