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Roth 401(k)

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What is it?

A "Roth 401(k)" is simply a 401(k) plan that allows employees to designate all or part of their elective deferrals as qualified Roth 401(k) contributions. Qualified Roth 401(k) contributions are made on an after-tax basis, just like Roth IRA contributions. This means that there's no up-front tax benefit, but if certain conditions are met, employees' contributions and earnings are entirely free from federal income tax when distributed from the plan. This article discusses qualified Roth 401(k) contributions.

> **Caution:** State tax laws may differ from federal law. Consult your pension advisor for the tax impact in your particular state.

> **Caution:** 401(k) sponsors don't have to allow Roth contributions to their plans. But if they do, the 401(k) plan can't be a "Roth only" plan. That is, if the 401(k) plan allows Roth contributions then employees must be allowed to make both Roth contributions and pre-tax contributions.

> **Tip:** SIMPLE 401(k) and safe-harbor 401(k) plans can also allow Roth contributions.

> **Tip:** 403(b) Plans can also permit Roth contributions. The rules discussed in this article generally apply to Roth 403(b) accounts as well.

Roth 401(k) contributions

In general

Technically, an employee makes a Roth 401(k) contribution by making an elective deferral under the 401(k) plan, and then irrevocably designating all or part of that deferral as a Roth 401(k) contribution. Roth 401(k) contributions are treated the same as pre-tax 401(k) elective deferrals for all plan purposes, except that they're included in an employee's wages for tax purposes at the time of contribution (i.e., Roth 401(k) contributions are after-tax contributions).

A 401(k) plan must establish a separate Roth 401(k) account to track each employee's Roth 401(k) contributions. The Roth 401(k) account is treated as a "separate contract" under the 401(k) plan, requiring separate accounting for the Roth contributions and any gains or losses on those contributions. The taxation of distributions from the Roth account is also determined separately from any other plan dollars.

> **Tip:** Even though a Roth 401(k) account is treated as a "separate contract," the amount a participant can borrow, or withdraw on account of hardship, is determined based on the participant's combined Roth and non-Roth plan account balances. In addition, Roth and non-Roth account balances are combined to determine whether a participant's vested accrued benefit is $5,000 or less, allowing it to be involuntarily cashed-out upon termination of employment. However, the Roth and non-Roth account balances are treated separately when determining whether a cashed-out participant's vested accrued benefit exceeds $1,000, requiring an automatic rollover to an IRA in some cases.

Eligibility

Any employee who's eligible to participate in a 401(k) plan can make Roth contributions (assuming the plan allows Roth contributions). Unlike Roth IRAs, no income restrictions apply to a Roth 401(k) program. Even highly paid employees who aren't eligible to contribute to a Roth IRA can make Roth 401(k) contributions.

Contribution Limits

Because Roth contributions to a 401(k) plan are treated as elective deferrals, careful attention must be paid to the elective deferral limits. In 2011, an employee can't contribute more than $16,500 of his or her compensation to a 401(k) plan. Participants who are age 50 or older may also make additional "catch-up" contributions of up to $5,500 in 2011.

> **Caution:** These limits apply to the aggregate elective deferrals (including both pre-tax contributions and after-tax Roth contributions) that an employee makes during a year to any 401(k) plan, 403(b) plan, SAR-SEP, or SIMPLE plan, whether or not sponsored by the same employer. The employee is responsible for making sure the overall limit isn't exceeded if he or she participates in plans of more than one employer during a calendar year.

> **Example(s):** Joe begins working for a new employer on July 1, 2011. Joe has already made $10,000 of elective contributions ($5,000 Roth and $5,000 pre-tax) to his former employer's 403(b) plan in 2011. Joe can only contribute an additional $6,500 to his new employer's Roth 401(k) plan in 2011 ($12,000 if Joe is age 50 or older).

> **Caution:** If an employee contributes too much in any particular year, the employee must withdraw the excess (and applicable earnings) by April 15 of the following year to avoid adverse tax consequences. If an employee fails to do so, the excess Roth 401(k) contributions, which normally would be tax-free, and applicable earnings, will be subject to income tax (and a potential early distribution penalty) when distributed from the plan, and will not be eligible for rollover to another employer plan or IRA. A distribution of excess Roth deferrals and applicable earnings can not be a tax-free qualified distribution.

Total annual additions to an employee's 401(k) plan account in 2011--including employer contributions, forfeitures, and employee pretax, Roth, and non-Roth after-tax contributions--can't exceed $49,000 (plus any allowable catch-up contributions). You must treat all defined contribution plans you maintain (including qualified plans, 403(a) annuity plans, 403(b) plans, stock bonus plans, and SEPs) as a single plan for purposes of calculating the annual additions limit (SIMPLE IRA plans are not included).

Treatment of Roth 401(k) contributions as elective contributions

Roth 401(k) contributions are treated as elective deferrals for all 401(k) plan purposes. That is, except for the tax treatment, they are treated the same as pre-tax 401(k) contributions.

For example, Roth 401(k) contributions:

- Can be distributed only for one of the following reasons: severance from employment, age 59½, disability, hardship, or death (and a hardship distribution will generally trigger a minimum six-month suspension penalty)
- Must be included with pre-tax contributions when performing 401(k) nondiscrimination testing
- Must be distributed starting at age 70½ (or, in some cases, after retirement)
- Can be borrowed (if the plan allows)
- Qualify for the retirement plan "Saver's Credit"

Employer contributions

An employer can match employees' Roth 401(k) contributions, pre-tax contributions, or both, but employer contributions are always made on a pre-tax basis, even if they match employees' Roth 401(k) contributions. That is, employer matching contributions, and earnings on those contributions, aren't added to an employee's Roth 401(k) account. They will be subject to federal (and most state) income taxes when distributed from the 401(k) plan regardless of whether they match an employee's pre-tax or Roth 401(k) contributions.

A 401(k) plan can require that an employee have up to 6 years of credited service before the employee is fully vested in employer matching contributions.

> **Tip:** While employers aren't required to contribute to traditional 401(k) plans many employers match all or part of their employees' contributions. Employer's can also make discretionary profit-sharing contributions to a 401(k) plan. (Special rules apply to SIMPLE 401(k) plans, safe-harbor 401(k) plans),

and 401(k) plans that contain a safe-harbor qualified automatic contribution arrangement (QACA).)

Tax considerations

In general

Unlike traditional 401(k) contributions, which are made on a pre-tax basis, Roth 401(k) contributions are made on an after-tax basis. That means there is no up-front tax benefit at the time employees contribute to the plan. Employees cannot exclude or deduct the contribution from wages. Because an employee's Roth 401(k) contributions are subject to income tax at the time the employee makes the contribution, those contributions are generally tax-free when distributed from the plan. Earnings grow tax deferred and are tax free when paid from the plan if the conditions for a qualified distribution are met.

Qualified distributions

Qualified distributions from Roth 401(k) accounts are entirely free from federal income taxes. A qualified distribution is a payment from an employee's Roth 401(k) account that meets both of the following requirements:

- The payment is made after the employee turns age 59½, becomes disabled, or dies, and
- The payment is made after the five-year period that starts with the year the employee makes his or her first Roth contribution to the 401(k) plan

Tip: If a qualified distribution includes employer securities, the participant's basis in those securities is the fair market value of the securities at the time they're distributed. Any additional appreciation will be taxed as long term or short term capital gains, depending on how long the participant holds the securities following the distribution from the plan. If a nonqualified lump-sum distribution includes employer securities, the participant may be able to elect net unrealized appreciation (NUA) treatment.

Tip: The age, death, and disability of the plan participant are used to determine whether a distribution is qualified in the case of a payment to the participant's beneficiary, or to an alternate payee under a qualified domestic relations order ("QDRO"). But if the alternate payee or a spousal beneficiary rolls the distribution over into his or her own employer's Roth 401(k) plan, then the age, death, or disability of the alternate payee/spousal beneficiary controls when determining whether or not a subsequent distribution from his or her Roth 401(k) plan is a qualified distribution.

Caution: IRS regulations provide that certain distributions, like distributions of excess Roth 401(k) contributions and deemed loan distributions, can never be qualified distributions.

Five-year waiting period

One of the requirements for a qualified distribution is that it must be made after a five-year period of participation. In general, the five-year period begins on the first day of the first calendar year a participant makes a Roth 401(k) contribution (regular or rollover) to the plan. The five-year period ends when five consecutive taxable years have been completed.

Example(s): Nicole makes her first Roth 401(k) contribution to her company's 401(k) plan in December of 2008. Nicole's five-year waiting period begins January 1, 2008. Her five-year waiting period ends December 31, 2012.

Caution: Certain contributions don't start the five-year holding period. For example, if all of a participant's Roth contributions for a year are excess deferrals, those contributions will not start the five-year holding period. Similarly, contributions returned to the participant as an excess contribution (to prevent the plan from failing nondiscrimination requirements), and certain contributions returned to a participant from a 401(k) plan with an auto-enrollment feature will not start the five-year period.

The five-year waiting period is determined only once for a particular Roth 401(k) plan participant. For example, if Sarah participates for 10 years, receives her entire Roth 401(k) account balance as a qualified distribution, and then starts contributing to the same plan again, she won't need to satisfy a new five-year waiting period.

When an employee makes Roth 401(k) contributions to plans maintained by different employers, the five-year holding period is determined independently for each Roth account. But an important exception applies--if an employee makes a direct rollover of Roth dollars from a prior employer's plan to a new employer's plan, the five-year holding period for the new plan will start with the year the employee made his or her first Roth contribution to the prior plan.

> **Caution:** This special rule applies only to direct rollovers. If an employee receives a distribution, and then makes a 60 day rollover to another employer's 401(k) plan, the holding period from the first plan will not apply.

> **Example(s):** Jim makes Roth contributions to Acme Corporation's 401(k) plan beginning in 2008. In 2011, Jim leaves Acme and joins Beacon Corporation, and begins making Roth contributions to Beacon's 401(k) plan. Jim will have two separate five-year holding periods--one for his Acme Roth account (which will end December 31, 2012) and another for his Beacon Roth account (which will end December 31, 2015). In 2011 Jim decides to make a direct rollover of his Acme Roth account to Beacon's 401(k) plan. Jim's holding period for his Acme Roth account will carry over to his entire Beacon Roth account, and Jim can now receive tax-free qualified distributions from the Beacon 401(k) plan beginning in 2013 (assuming Jim is 59½ by then).

> **Tip:** If a spousal beneficiary, or an alternate payee under a QDRO, rolls a distribution over into his or her own employer's Roth 401(k) plan, then the five-year waiting period for determining whether subsequent distributions from the receiving plan are qualified begins on the earlier of (a) the date the employee's 5-year period began under the distributing plan, or (b) the date the spousal beneficiary/alternate payee's made his or her first Roth contribution to the receiving plan.

Nonqualified distributions

If a payment does not satisfy the conditions for a qualified distribution, the portion of the payment that represents the return of an employee's own Roth contributions will be tax free, but the portion of the payment that represents earnings on those contributions will be subject to income tax and a potential 10-percent premature distribution tax unless an exception applies.

> **Tip:** IRS regulations provide that each distribution from a Roth 401(k) account is deemed to consist of a pro-rata share of an employee's Roth contributions and investment earnings on those contributions.

A distribution that's made before the 5-year waiting period has elapsed will always be a nonqualified distribution. A distribution that's made prior to the earliest of attainment of age 59½, disability, or death (for example, a distribution to an employee upon termination of employment before age 59½) will also always be a nonqualified distribution.

Rollovers

In general, employees can roll over distributions from their Roth 401(k) account to another Roth 401(k) or Roth 403(b) account, if the new employer's plan accepts Roth rollovers. Nontaxable dollars must be rolled over in a direct (trustee to trustee) rollover only--a 60 day rollover is not permitted. Employees can also roll over Roth 401(k) distributions to a Roth IRA. Distributions from Roth 401(k) accounts cannot be rolled over into any other retirement plan.

IRS regulations provide that separate five-year holding periods apply to Roth 401(k) accounts and Roth IRA's. A rollover from a Roth 401(k) plan to a Roth IRA does not affect the Roth IRA's five-year holding period, regardless of how long the dollars rolled over resided in the 401(k) plan.

If an employee receives a qualified distribution from a Roth 401(k) plan and rolls it over into a Roth IRA, the entire amount rolled over will be treated as a contribution by the employee to the Roth IRA. The employee can withdraw this amount tax free from the Roth IRA at any time. Any additional earnings will be subject to the Roth IRA's five year holding period.

If an employee receives a nonqualified distribution from his or her Roth 401(k) account and rolls it over into a Roth IRA, only the amount of the employee's Roth contributions to the 401(k) plan, not the investment earnings, will be treated as a contribution to the Roth IRA. The investment earnings rolled over, along with any additional investment earnings, will be subject to the Roth IRA's five-year holding period.

Example(s): Jane, who is 56, begins making Roth contributions to her employer's 401(k) plan in 2008. Her five-year holding period in the 401(k) plan ends December 31, 2012. In 2011, at age 60, Jane terminates her employment and decides to roll over her Roth 401(k) account to a Roth IRA, the first she has established. The distribution is not qualified because Jane has not satisfied Roth 401(k) five-year holding period. The distribution consists of $10,000 of Jane's Roth 401(k) contributions, and $2,000 of investment earnings. The $10,000 will be treated as a contribution to the Roth IRA, which Jane can withdraw tax-free at any time. The $2,000, however, will be treated as investment earnings in the Roth IRA. Because Jane established her first Roth IRA in 2011, the earliest she can receive a qualified distribution of investment earnings from the Roth IRA is 2016. She has effectively lost the four years she held those dollars in the 401(k) plan. Jane should have waited one more year to make her rollover.

Example(s): Ann is 40 years old. She starts making Roth contributions to her employer's 401(k) plan in 2008. After 10 years, Ann terminates her employment and decides to roll over her Roth 401(k) account to a Roth IRA, the first she has established. The distribution consists of $150,000 of Ann's Roth 401(k) contributions, and $75,000 of investment earnings. Even though Ann has satisfied the 401(k) plan five-year holding period, the distribution is nonqualified because Ann is not 59½ or disabled. The $150,000 will be treated as a contribution to the Roth IRA, which Ann can withdraw tax-free at any time. The $75,000, however, will be treated as investment earnings in the Roth IRA. Because Ann established her first Roth IRA in 2018, the earliest she can receive a qualified distribution of those investment earnings from the Roth IRA is 2023.

Caution: Hardship distributions, required minimum distributions, certain periodic payments, and distributions of excess contributions generally can't be rolled over into any other retirement plan.

Annuity contracts

The distribution of an annuity contract from a Roth 401(k) plan account to a plan participant is not a taxable event. Rather, the taxable event occurs when distributions from the annuity contract are made to the participant. The period after the annuity contract is distributed, and before the participant receives a distribution from the contract, counts in determining whether the participant's five-year waiting period for qualified distributions is satisfied. Whether the participant is age 59 ½ or disabled is also determined at the time of the distribution from the annuity contract.

Example(s): Joe makes his first Roth 401(k) contribution to his employer's plan in 2008, at age 56. In 2010, at age 58, Joe terminates employment and receives an annuity contract representing his Roth contributions and earnings. In 2013, at age 61, Joe receives a distribution from the annuity contract. The distribution from the annuity contract is qualified, and will be free from federal income tax, because, at the time of the distribution, Joe has satisfied the five-year waiting period and has reached age 59½.

Adding a Roth 401(k) feature to an existing 401(k) plan

If you currently sponsor a 401(k) plan and want to add a Roth 401(k) feature, you will need to amend your 401(k) plan document to specifically allow Roth 401(k) contributions, and to specify the distribution rules that will apply to those contributions. You must also amend your employee communication materials (e.g., summary plan descriptions or "SPDs") to describe the new option to your employees. You may also need to file your amended plan with the IRS. Your plan attorney and recordkeeper should be able to assist you in establishing and administering a Roth 401(k) program. In addition to amending your plan, you must:

- If your 401(k) plan provides for automatic enrollment, your plan must specify whether the employee's default contributions will be pre-tax or Roth contributions
- Maintain a separate account within your 401(k) plan for each employee's Roth 401(k) contributions, and allocate earnings and losses on a consistent and reasonable basis to those accounts
- Maintain a record of the amount of each employee's Roth 401(k) contributions, and the amount of contributions that have been distributed to the employee (i.e., you must maintain a record of the employee's basis in order to report distributions properly)
- Track the five-year holding period for each employee

- Do not allocate any plan forfeitures to an employee's Roth 401(k) account
- When executing a direct rollover from an employee's Roth 401(k) account to another employer's 401(k) or 403(b) plan, provide the receiving plan with either (a) a statement that the rollover is a nontaxable qualified distribution, or, if the distribution is not qualified, (b) a statement indicating the year of the employee's first Roth contribution to the plan, and the portion of the distribution representing the employee's basis. This information must be provided to the employee upon his or her request if the distribution isn't a direct rollover.

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