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A 2013 Change In Law Makes Designated Roth Accounts More Attractive

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Since 2006, employers have been permitted to add a designated Roth account to their 401(k) plans (or certain other cash or deferred arrangements). A designated Roth account, known as a Roth 401(k), is a separate account to which designated Roth (i.e., after tax) contributions are permitted in lieu of pretax elective contributions. A participant can designate all or a portion of a contribution to be made to his or her Roth 401(k), but once a contribution is made it cannot be changed. The plan sponsor must separately account for all contributions, distributions and earnings in the Roth 401(k). Generally, for most other purposes, such as nondiscrimination testing and restriction on in-service distributions, a Roth 401(k) is treated as if it were a pretax contributions account.

Because they are made after tax, the contributions to a Roth 401(k) are subject to tax as ordinary income when they are made (or, as discussed later, in the year of an in-plan Roth rollover), but unlike other retirement accounts, any later, qualified withdrawals are completely free of income tax. In order for a withdrawal from a Roth 401(k) to be tax-free, it must be made:

1. at least five years after the participant in a 401(k) plan first made a Roth 401(k) contribution and
2. on or after the date the participant:
   a. attains age 59½,
   b. becomes disabled or
   c. dies.

These rules are similar to those governing traditional Roth IRAs.

2013 federal law increased the attractiveness of Roth 401(k) accounts. Now, if the plan so provides, an in-plan Roth rollover can be made without regard to whether the amount is otherwise distributable. Thus, a participant who is not eligible for a distribution because he or she is employed and has not attained age 59½ can make an in-plan Roth rollover from his or her pretax 401(k) account. For example, a plan participant who is age 50 can make an in-plan Roth rollover to his or her Roth 401(k). The rollover distribution would be subject to income tax in the year of the rollover, just like an outright lump sum distribution from a pretax contributions account. However, any later withdrawals would be completely free of income tax if the requirements set forth in the second paragraph above are satisfied.

> "Unlike other retirement accounts, any later, qualified withdrawals are **completely free** of income tax."

Since 2010, a 401(k) plan having a designated Roth account can permit an in-plan Roth rollover — that is, a distribution from an individual's plan account (which is otherwise distributable to the participant), other than from a Roth 401(k), that is rolled over to the individual's Roth 401(k) in the same plan. Any vested amount held in a plan account for a plan participant is eligible for an in-plan Roth rollover to a Roth 401(k) in the same plan. An election by a participant to make an in-plan Roth rollover is irrevocable. This option is available to the participant or his or her surviving spouse. As a result of the U.S. Supreme Court decision that declared Section 3 of the Defense of Marriage Act unconstitutional, a surviving spouse includes a same sex spouse if the couple married in a state or country that recognizes same sex marriages.

There are several significant differences between a Roth 401(k) and a traditional Roth IRA that should be borne in mind. These include:

who's who

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1. **Income Limits:** A participant can make a contribution to his or her Roth 401(k) regardless of how high his or her compensation or other income is. However, an individual cannot make a contribution to a Roth IRA if modified adjusted gross income is equal to or more than $188,000 if married or $127,000 if single.
2. **Maximum Contributions:** A participant can make an annual contribution to his or her Roth 401(k) up to a maximum of $17,500 ($23,000 if age 50 or older). The maximum annual contribution to a Roth IRA is only $5,500 ($6,500 if age 50 or older).
3. **Loans:** 401(k) plans can permit loans from a participant's Roth 401(k). Loans are not permitted from a Roth IRA.
4. **The Five Year and Required Minimum Distributions Rules:** One of the requirements for a distribution from a Roth 401(k) to be free of income tax is that it must be made at least five years after the participant in a 401(k) plan first made a contribution to his or her Roth 401(k). If the participant rolls over his or her Roth 401(k) into a newly established Roth IRA, the five-year rule begins again and distributions cannot be entirely tax-free until at least five years after the rollover. One reason for such a rollover is that a Roth 401(k) participant is subject to the required minimum distributions rules. There are no required minimum distributions rules applicable to an owner of a Roth IRA. For a Roth IRA, the required minimum distributions rules only apply to a designated beneficiary after the death of the Roth IRA owner.

The popularity of the Roth 401(k) among large employers is growing. A January 2013 survey by Aon Hewitt of large U.S. employers (those with more than 1,000 employees) revealed that while almost half (49%) of respondents currently offered no Roth 401(k), 29% of those that didn't offer a Roth 401(k) said they were very or somewhat likely to add this feature in the next 12 months.

However, studies show that participants in 401(k) plans that offer a Roth 401(k) account have been cool to making contributions to a Roth 401(k). Part of the problem is that while the Roth 401(k) is fairly simple to understand, determining whether it is a good choice for a particular participant is often anything but simple, requiring a careful assessment of a participant's age, current and future tax situation, assets outside the 401(k) and current and future cash flow requirements.

Thus, although adding a designated Roth account to a 401(k) plan is gaining popularity among employers, it is vitally important that participants are given clear and adequate guidance so they can determine whether making contributions to a Roth 401(k) is in their best interests.