IRS Guides for In-House Conversions in Roth 401(k)

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Before we get started, what exactly is a Roth 401(k)?

A Roth 401(k) contribution works like a regular 401(k) contribution as it comes directly from your paycheck into your own retirement account. However, with the Roth the contributions are made with **post tax dollars**. The annual limit on Roth 401(k) contributions is the same as the limit for traditional 401(k) plans. Therefore, in 2014 you can contribute up to $17,500; or $23,000 if you are age 50 or older. The main benefit of a Roth 401(k) comes when you get the money years down the road in retirement. As long as the Roth 401(k) has been in existence at least five years, qualified distributions are completely tax-free. Yes, I said the distributions are tax free! For this purpose, qualified distributions include distributions made after age 59½, on account of death or disability, or if the funds are used for first-time homebuyer purchases (up to a lifetime limit of $10,000).

Interestingly enough, the Roth 401(k) plan feature has been around for some time as it combines some of the benefits of a traditional 401(k) plan with a Roth IRA. Typically, an employer will add this feature to an existing 401(k) plan. Now, the IRS has issued a new notice governing in-house rollovers to a Roth 401(k).

So What's New?

Due to a recent tax law change, an employee participating in a 401(k) can now choose to transfer any amount otherwise not distributable under the plan to a designated Roth account. Thus, you can roll over funds within the same 401(k) plan without paying the 10% penalty tax for pre-age 59½ distributions, although the transfer is subject to regular income tax.

In the new notice, the IRS explained the rules for rolling over amounts from a traditional 401(k) account to a designated Roth account without leaving the firm or otherwise triggering a distribution. If an amount is rolled over to a designated Roth account, the amount rolled over, plus any earnings, remains subject to the distribution restrictions in place before the in-plan Roth rollover. No withholding is required.

This is unique because Roth IRAs are typically limited to income earners less than $120,000 for single filers and less than $191,000 for married filing jointly. Finally a solution exists to give high income earners an ability to utilize the planning tools offered by a Roth! It's an IRS miracle! Perhaps that is an overstatement, but you get the point.

Other rules include that the plan may limit the type of contributions eligible for an in-plan Roth rollover and the frequency of such rollovers. A plan with an ongoing qualified Roth contribution plan would not violate the tax law if it discontinued in-plan Roth rollovers. However, an amendment to eliminate in-plan Roth rollovers is subject to rules about whether the timing of a plan amendment discriminates in favor of highly compensated employees.

Furthermore, if an in-plan Roth rollover is the first contribution made to an employee's designated Roth account, the required five-year period of participation for qualified distributions begins on the first day of the first tax year in which the employee makes the in-plan Roth rollover.

Usually, a plan amendment must be adopted by the last day of the first plan year in which the amendment is effective. But the new notice extends the deadline to December 31, 2014, for the 2013 plan year. See your professional advisers for more information about how this works, and if it makes sense for you to take advantage of it!

Each individual's situation may vary, be sure to consult with your own legal and tax advisers before taking any action that may have tax implications.

Who is Wealth Management?

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