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TOPIC: "Mega Roth" – Maximizing Tax-Free Earnings with In-Plan Roth Conversions of After-Tax Contributions

MARKET TREND: An increasing number of employers sponsoring tax-qualified 401(k) plans ("401(k) Plans") have added Roth contribution features to their plans. With the growing popularity of Roth contributions, employers may also want to consider adding a new feature to their plans that permits participants to make additional after-tax contributions and then convert those contributions into a Roth account under the 401(k) Plan (an "In-plan Roth Conversion"). This conversion enables participants to benefit from tax-free growth on both their Roth contributions to the 401(k) Plan and on their after-tax contributions following the In-plan Roth Conversion, each in exchange for current income recognition. This design is sometimes referred to as a "Mega Roth."

SYNOPSIS: An In-plan Roth Conversion feature may confer a windfall for long-term savers by permitting tax-free growth on funds that would otherwise have been subject to federal income taxation, but only if certain requirements imposed on both the 401(k) Plan and participant are satisfied. Because a 401(k) Plan participant would have to contribute in excess of $19,000 in 2019 ($25,000 if age 50 or older) to be eligible to take advantage of an In-plan Roth Conversion, the feature favors highly compensated employees ("HCEs"). Depending on the composition of the 401(k) Plan's participants and plan design, extra after-tax contributions by HCEs to take advantage of an In-plan Roth Conversion feature may make it more difficult for the 401(k) Plan to pass nondiscrimination testing. But for 401(k) Plans able to offer an In-plan Roth Conversation and participants able to use it, a material benefit may be obtained as shown more fully below.

TAKEAWAYS: Employers adding Mega Roth features to their 401(k) Plans may enable participants to increase their retirement assets' tax-free growth. However, certain regulatory hurdles such as nondiscrimination testing may prevent many 401(k) Plan participants from using this feature, even if their plan offers it. Adding a Mega Roth feature also requires a plan amendment and updates to participant communications. And, on a practical level, Mega Roth features will likely only benefit HCEs due to the sizeable annual 401(k) Plan contribution required to take advantage of the Mega Roth benefit.

How Does a Mega Roth Work?

By way of background, annual contributions to a 401(k) Plan are statutorily capped at the lower of: (i) a participant's annual income and (ii) $56,000 for participants under age 50 and $62,000 for participants aged 50 and over in 2019 (the "Overall Limit"). Of the Overall Limit, participants may contribute up to $19,000 ($25,000 if 50 or older) in 2019 as either pre-tax contributions or Roth contributions (the "Deferral Limit"). The amount of the Overall Limit and Deferral Limit are annually indexed to inflation and periodically adjusted by the Internal Revenue Service. Participants making pre-tax contributions do not recognize income for federal income tax purposes until they withdraw those amounts from the 401(k) Plan, at which time participants will recognize income both on amounts contributed to the 401(k) Plan and the earnings that have accrued on contributions. For Roth contributions, participants recognize income for federal income tax purposes currently, but once contributed to the 401(k) Plan, Roth contributions grow tax-free. Participants do not owe federal income tax upon withdrawing Roth contributions and related earnings from the 401(k) Plan if certain age and holding period requirements are met.

The $37,000 ($43,000 for participants age 50+) portion of the Overall Limit not allocated to pre-tax and/or Roth contributions may consist of employer matching contributions, employer nonelective contributions, allocations of forfeitures, and after-tax employee contributions. As a result, the maximum amount a participant may contribute to the 401(k) Plan as after-tax employee contributions is reduced dollar-for-dollar by any amounts employer contributes to the plan as matching or nonelective contributions or that are allocated from forfeitures.

In the Mega Roth design, participants can make after-tax employee contributions up to the Overall Limit (subject to nondiscrimination testing limits discussed below), and then have those contributions converted to Roth contributions through an In-plan Roth Conversion. For this design to work, the 401(k) Plan must include provisions that permit (i) Roth contributions (up to the Deferral Limit), (ii) after-tax employee contributions, and (iii) In-plan Roth Conversions. A 401(k) Plan that does not have all of these features may be amended to add the missing features, but those amendments must be timely adopted.

Participants in eligible 401(k) Plans can then make a Mega Roth contribution as follows:

- First, the participant contributes pre-tax and/or Roth contributions to the 401(k) Plan up to the Deferral Limit and receives any employer matching and/or nonelective contributions.

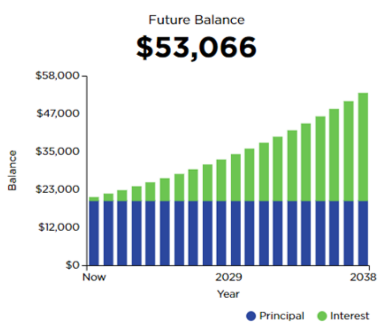
- Second, the participant contributes additional money to the 401(k) Plan as an employee after-tax contribution up to the Overall Limit.

- Third, the participant converts the after-tax contributions into a Roth account through an In-plan Roth Conversion.

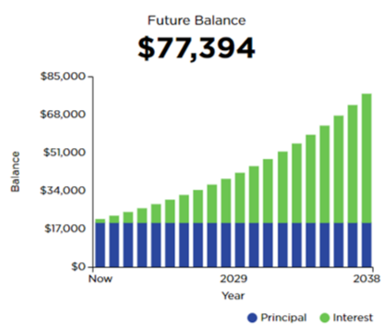
Advantage of In-plan Roth Conversions

The earnings on the after-tax contributions converted to a Roth account in an In-plan Roth Conversion will be tax-free if the monies subject to the In-plan Roth Conversion are distributed after the participant attains age 59-1/2 and the amounts being distributed were held in the 401(k) Plan for at least five years (a "Qualified Distribution").

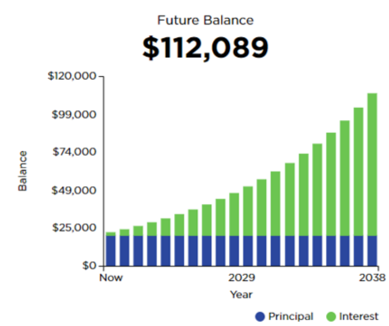
For participants that may make an In-plan Roth Conversion and receive a Qualified Distribution, the following graphs show the potential investment earnings for a participant making a one-time $20,000 In-plan Roth Conversion at 5%, 7% and 9% interest rates over 20 years.



5% = $33,066 in tax free investment earnings



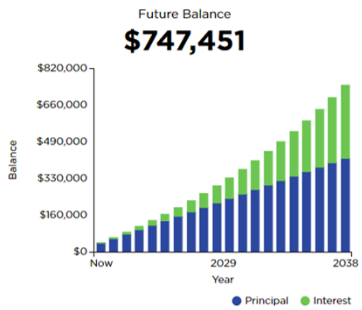
7% = $57,394 in tax free investment earnings



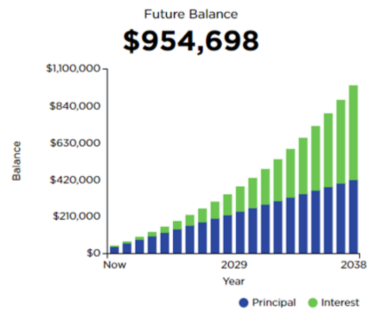
9% = $92,089 in tax free investment earnings

Assuming static tax rates and that the participant in the example above would have invested the same $20,000 in a non-tax advantaged investment with similar investment returns, making an In-plan Roth Conversion saved the participant approximately $4,960, $8,609, and $13,813 in capital gains taxes (assuming a 15% rate) at 5%, 7%, and 9% investment returns, respectively.

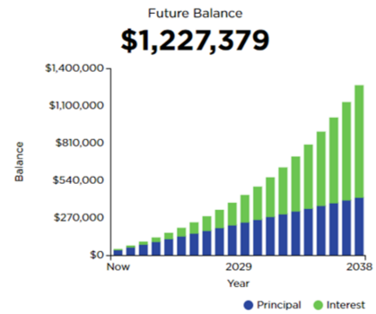
By making a $20,000 In-plan Roth Conversion annually for 20 years, the participant magnifies the advantages of an In-plan Roth Conversion, as shown in the graphs below, which use the same 5%, 7% and 9% interest rates over the 20 years.



5% = $347,451 in tax free investment earnings



7% = $554,698 in tax free investment earnings



9% = $827,379 in tax free investment earnings

Technical Considerations

The benefits of the Mega Roth design are clear, but employers evaluating whether to add this feature to their 401(k) Plans should consider several technical legal issues before proceeding.

Non-discrimination Testing. The primary consideration should be whether the employee after-tax contributions will adversely impact their 401(k) Plan's ability to pass nondiscrimination testing. After-tax contributions are subject to the actual contribution percentage ("ACP") nondiscrimination test. The ACP test compares the average contribution percentages (after-tax contributions and company match, if any) of HCEs and non-highly compensated employees ("NHCEs"). The ACP of HCEs may not exceed the ACP of NHCEs by more than the legal limit. Note that although a safe harbor 401(k) Plan automatically satisfies the ACP test as to safe harbor matching contributions, after-tax contributions are nevertheless required to be tested and may be combined with matching contributions for this purpose. If the 401(k) Plan fails the ACP test, then the after-tax contributions of the HCEs must be limited and any discriminatory excess contributions refunded to HCEs. Employers can minimize the risk of failing the ACP test by modeling the test in advance and capping after-tax contributions as necessary. For some employers, the nondiscrimination testing limits may make the Mega Roth design of limited or no value.

Federal Tax Treatment. In an In-plan Roth Conversion, money never actually leaves the 401(k) Plan; instead, it is transferred from the participant's after-tax contribution account to his or her In-plan Roth Conversion account. For Federal income tax purposes, the conversion amount is treated as if it was distributed from the 401(k) Plan and then immediately recontributed by the participant to the 401(k) Plan. If the In-plan Roth Conversion occurs after the converted after-tax contributions have been allocated, those earnings will be taxed as part of the conversion. While there is no withholding required on the converted amount, the participant must pay the relevant taxes from sources outside of the 401(k) Plan.

No Early Withdrawal Penalty. Participants under age 59-1/2 who elect an In-plan Roth Conversion are not subject to the 10% additional income tax that would normally apply to a pre-age 59-1/2 distribution from the 401(k) Plan.

Five-Year Holding Period. Each In-plan Roth Conversion has a new five-year clock attached to it in order to be considered a Qualified Distribution. So, for example, if a participant were to convert after-tax money on December 31, 2020, the five-year clock would expire December 31, 2025, and any distributions of those monies after that date would be considered a Qualified Distribution (if the participant is also at least age 59-1/2). If a participant were to subsequently convert after-tax money on December 31, 2021, that money would have a new five-year clock, expiring December 31, 2026. This rule could be problematic for participants close to retirement if they plan to withdraw funds in the first few years following retirement.

Final Thoughts

A Mega Roth, accomplished through an In-plan Roth Conversion, can offer a material financial benefit to eligible participants. Because Mega Roths can practically only be used by HCEs, adding an In-plan Roth Conversion feature to their 401(k) Plans is not for every employer. But, for those employers looking to offer an extra tax and retention benefit to their HCEs, adding an In-plan Roth Conversion feature to their 401(k) Plans may be an attractive option. Before proceeding employers should model the ACP test to ensure that increased after-tax employee contributions won't cause the plan to run afoul of the nondiscrimination testing rules. Assuming the addition of an In-plan Roth Conversion feature is acceptable from a compliance perspective, employers should work with ERISA counsel to discuss the next steps in adding an In-plan Roth Conversion feature to their 401(k) Plan(s). The next steps will typically include obtaining corporate governance approvals, amending the 401(k) Plan document, and preparing participant communications regarding the addition of an In-plan Roth Conversion feature and how participants can take advantage of it.