

Employee Benefits Corner

By Elizabeth Thomas Dold and David N. Levine

A New Plan Design Feature—The “In-Plan” Roth Conversion

Effective September 28, 2010, section 2112 of the “Small Business Jobs and Credit Act of 2010” (H.R. 5297) (“the Act”) added a new design feature to 401(k) and 403(b) plans to permit a conversion of certain non-Roth amounts that are eligible for rollover to be converted to Roth amounts and remain in a tax-advantaged plan. A summary of the prior law is set forth below, along with a summary of the new provision and implementation steps in order to add the feature. Lastly, we discuss the impact of Roth conversion on governmental 457(b) plans.

Summary of Prior Law

Under prior law, pursuant to a provision in the Economic Growth and Tax Relief Reconciliation Act of 2001 with a delayed 2006 effective date, a participant was permitted to make salary deferral contributions as after-tax Roth contributions to a tax-qualified Code Sec. 401(k) or Code Sec. 403(b) plan. These contributions were limited to \$16,500 per year for 2011 (and are combined with pre-tax deferrals for purposes of applying the \$16,500 limit). Under this feature, participants can make Roth contributions without regard to the income limits that apply to Roth IRA contributions (currently \$169,000/\$107,000 for married/single taxpayers). The participant could also roll over Roth deferrals to or from another tax-advantaged plan. But importantly, there was no way to convert existing employer contributions (e.g., matching and profit-sharing contributions) or pre-tax elective deferrals into Roth fund while inside a tax-qualified plan.

Individuals could, however, elect to roll over their qualified plan distribution to a Roth IRA. Under this rule that remains in effect, a rollover amount is



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taxable income (except to the extent that after-tax contributions are converted); however, for any 2010 conversions, a participant may pay tax on the conversion in two equal installments in 2011 and 2012. Moreover, for the first time, no income limits apply to Roth conversions beginning in 2010.

Various groups urged Congress to allow Code Sec. 401(k) and Code Sec. 403(b) plans to offer this conversion option without forcing participants to remove the funds from their employer's plan. Concerns were expressed about forcing participants into IRAs with different cost structures than employer plans, imposing burdens to decide on the IRA's investments, and the loss of ERISA protections. The Act adopts such a provision, effective after September 27, 2010. Moreover, effective January 1, 2011, the Act permits Roth 457(b) deferrals to be added to a governmental Code Sec. 457(b) plan.

Summary of the In-Plan Roth Conversion Feature

A summary of the new "in-plan" Roth conversion feature is set forth below.

- **Plans Covered.** The following types of plans may now provide for an in-plan Roth conversion feature: Code Sec. 401(k) plans, Code Sec. 403(b) plans, and beginning in 2011, governmental Code Sec. 457(b) plans. The provision does not apply to money purchase pension plans, profit-sharing plans or defined benefit plans (e.g., traditional or cash-balance plans) that do not have a Roth contribution feature. An in-plan Roth contribution feature may be added to a Code Sec. 401(k) (or Code Sec. 403(b)) plan, but it cannot be limited to Roth conversions. Therefore, a plan must also permit Roth elective deferrals if it is also amended to permit in-plan Roth conversions.
- **Optional Provision.** Unlike the right to roll over a distribution into a Roth IRA, which plans were required to offer beginning in 2008, there is no requirement that plan sponsors amend their plans to offer this feature. Instead, an in-plan Roth conversion feature is optional and can be added to a plan at any time. However, the feature does involve administration and communication steps in order to properly offer the feature. Moreover, some employers rushed to offer it by December 31, 2010, to allow participants to take advantage of the special tax election pursuant to which a participant can decide whether to pay taxes in 2010 versus 2011 and 2012 on his or her 2010 tax return.
- **Eligible Participants.** Once an in-plan conversion feature is added, generally any participant (including an active or former participant with an account balance in the plan) or spousal beneficiary who is eligible to receive an eligible rollover distribution may make a Roth conversion election. The election to convert may not be made available to nonspouse beneficiaries. There is no income limit or filing status restriction for this election.
- **Amounts Eligible for Conversion.** The conversion feature appears to apply to any type of vested contributions (and earnings thereon) that are "currently distributable" and would be treated as an eligible rollover distribution if distributed. These amounts may generally include (1) pre-tax Code Sec. 401(k) and Code Sec. 403(b) deferrals (and beginning in 2011, governmental Code Sec. 457(b) deferrals), and earnings thereon; (2) matching contributions, and earnings thereon; (3) profit-sharing contributions, and earnings thereon; and (4) after-tax contributions, and earnings thereon. For an active employee who has not yet reached age 59 1/2, the conversion feature will not be available for pre-tax deferrals as these amounts would not be currently distributable. It is unclear if a participant may be permitted to select the source of an in-plan Roth conversion (presumably, the terms of the plan document will control). In addition, basis allocation issues should be considered as part of implementing in-plan Roth conversions.
- **Direct or Indirect Rollovers Only.** An in-plan Roth conversion can be made through a direct rollover or indirect ("60-day") rollover. Moreover, the "distribution" underlying the in-plan Roth conversion must be an eligible rollover distribution, which excludes hardship distributions, required minimum distribution payments, lifetime payments, installment payments of 10 years or more, certain corrective distributions and other specified distributions.
- **Allowable In-Service Distributions.** In all cases, a plan sponsor will want to carefully consider how to amend its plan to address the types of contributions that may be eligible for distribution and, accordingly, eligible for the in-service Roth conversion feature. Pre-tax deferrals can be distributed upon reaching age 59 1/2 (as noted above); and employer contributions can be distributed if they are vested and have been in the plan for at least two years or the participant has

participated in the plan for at least five years. Plan ordering rules should be reviewed; presumably, special rules can be set forth for conversion amounts. Moreover, if a plan currently provides for an in-service distribution right, generally no withdrawal restriction can be imposed under the anti-cutback rules. However, if a plan sponsor adds a distribution right that only applies to Roth conversions, presumably, withdrawal restrictions can be imposed (e.g., retain restrictions on a prior source), but this new withdrawal right will be subject to nondiscrimination testing and anti-cutback protection going forward.

- **Recordkeeping.** In-plan Roth conversion amounts should be transferred (for bookkeeping purposes) to a Roth account, but no actual distribution is required for a direct rollover. Importantly, if separate investment directions may be made for different accounts, they should be reviewed to assure that a participant's assets are in the intended investment.
- **Required Minimum Distribution Rules.** Unlike the rule that applies to Roth IRAs (and amounts rolled into a Roth IRA), a participant's plan account will continue to be subject to the lifetime "required minimum distribution" rules that generally require distributions to begin at age 70 1/2 (or retirement, if later) for in-plan conversions.
- **Plan Amendment.** The Act does not address the need for, or timing of, a plan amendment to implement an in-plan Roth conversion feature. However, the legislative history expressly authorized the IRS to provide an appropriate remedial amendment period to implement this provision. Recently issued IRS guidance (Notice 2010-84) generally gives plan sponsors until December 31, 2011, to add this feature.
- **Qualified Distribution.** A significant advantage of the in-plan Roth conversion feature is that it permits participants to convert non-Roth assets into Roth assets under the current tax rates, and thereafter on a later distribution, if the distribution qualifies as a "qualified distribution" then the earnings that are accrued after the conversion date are tax-free (*i.e.*, never subject to federal income tax). Therefore, it is important to determine what rules apply for a "qualified distribution." The Code provides that in order to have a "qualified distribution," a participant must receive a distribution (1) that is made after a five-year period (generally beginning with the first tax year in

which the participant contributed to a Roth 401(k) account under the plan or under a prior plan that was rolled over to the current plan), and (2) made on account of (a) death, (b) disability, or (c) after a participant reaches age 59 1/2.

- **Reporting.** The fair market value of the converted funds shall be reported on the current year Form 1099-R in box 1 (gross distribution), the taxable portion of the conversion (determined as if the amounts were actually distributed) is reported in box 2a, any federal income tax withheld is reported in box 4, any basis recovery is reported in box 5, and code "G" is entered in box 7 (G4 for a spouse) for a direct rollover. Please note, the fact that the participant treats a 2010 conversion as taxable over the two-year period does not impact the Form 1099-R reporting.
- **Withholding.** For an in-plan Roth conversion made through a direct rollover, no amount would be required to be withheld for federal income taxes. Presumably, if the employer elects to permit withholding, a participant can elect an amount in accordance with Code Sec. 3402(p). It is also likely that to the extent an amount is withheld, it would be subject to the 10-percent early distribution tax under Code Sec. 72(t) (unless an exception applies), and a separate Form 1099-R would be required. This approach is consistent with the approach taken in Notice 2008-30 for Roth IRA conversions.
- **Code Sec. 72(t) Recapture.** If a participant takes a distribution of the Roth conversion amount within five years (measured from the first day of the tax year in which the conversion is made) and the participant had not yet reached age 59 1/2 (or does not meet another exception to the Code Sec. 72(t) 10-percent early distribution tax at the time of such later distribution), the distribution would be subject to Code Sec. 72(t), to the extent that would have applied in the year of the conversion.

Implementation Steps

Although the concept of a Roth conversion appears rather straight-forward, there are a number of important implementation steps that must be considered before a plan sponsor offers this new design feature. Steps to consider include the following:

- **Participant Communication.** The availability of a Roth conversion feature should be communicated to participants. This communication can

be drafted to serve as an “SMM” (summary of material modifications), but should be careful not to give tax advice.

- **Roth 401(k).** If a plan does not already offer a Roth 401(k)/403(b) deferral feature, it must add this feature to the Plan as part of offering the in-plan Roth conversion feature. A number of issues are raised when adding a Roth deferral feature, including (1) the election process, (2) eligible for loans, (3) impact on the cashout rules, (4) ordering rules for distributions, and (5) eligibility for hardship.
- **In-Service Distribution Rules.** A plan’s in-service distribution rights should be reviewed, and, to the extent permissible under the Code, these rights may be expanded to permit conversion of additional amounts (*i.e.*, certain employer contributions). The impact of nondiscrimination testing and the anti-cutback provisions should be considered prior to making any plan changes.
- **Roth Account.** In-plan Roth conversion amounts should be transferred (for bookkeeping purposes) to a Roth account, but no actual distribution is required for a direct rollover. If a new source account is used, then additional provisions should be considered when establishing the new source code, including (1) what fund restrictions and investment direction rules apply, (2) what withdrawal restrictions apply, (3) when is the source distributable (and what ordering rules apply), and (4) what five-year period applies for purposes of a “qualified distribution” and for purposes of Code Sec. 72(t) recapture (as discussed above).
- **Distribution Election Procedures.** A plan’s distribution election procedures should be revised to reflect the addition of an in-plan Roth conversion feature. These potential revisions include provisions addressing in-service withdrawals and distributions following termination of employment. For example, the distribution election procedures should incorporate an updated Code Sec. 402(f) notice (*i.e.*, the special tax notice for

eligible rollover distributions) that reflects the new Roth conversion feature (and the tax impact of making the election). (See Notice 2010-84 for sample language.) Spousal consent will not be needed for an in-plan Roth conversion through a direct rollover.

- **Form 1099-R Process.** An in-plan Roth conversion will be treated as a distribution that is reported on Form 1099-R. See above for the reporting and withholding considerations that apply.
- **Consultation with Service Providers.** Because many plan recordkeeping features are regularly outsourced to other service providers, a plan sponsor should consider whether there is a need to consult with these providers before implementing an in-plan Roth conversion feature. Taking this step may often reduce the potential for future operational errors requiring correction under the Employee Plans Compliance Resolution System.

Governmental 457(b) Plans

The Act allows governmental Code Sec. 457(b) plans—the functional equivalent to Code Sec. 401(k) plans for state and local government employees—to include Roth features beginning in 2011. Because Code Sec. 457(b) and Code Sec. 401(k)/403(b) deferrals are not combined, participants in multiple plans could elect the maximum amount of Roth elective deferrals in one plan and maximum amount of pre-tax elective deferrals in another plan.

As these plans will be able to add Roth deferrals, governmental employers might also consider if the Roth conversion feature should also be added. The implementation steps that are discussed above also generally apply to governmental plans, although such plans are generally not subject to nondiscrimination and anti-cutback rules under federal law.

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