Legal Developments

A New Plan Design Feature for Qualified Plans: The Roth "In-Plan" Rollover

Effective on or after September 28, 2010, Section 2112 of the "Small Business Jobs and Credit Act of 2010" (H.R. 5297) (the "Act") added a new design option for 401(k) and 403(b) plans effective September 29, 2010, and for governmental 457(b) plans effective January 1, 2011. That option is the ability to permit a conversion of certain non-Roth amounts to a designated Roth account within the same plan. A summary of the prior law is set forth below, along with a summary of the new provision and the IRS guidance issued in Notice 2010-84 to facilitate implementing this provision. Lastly, the article reviews the key implementation steps when adding the new Roth rollover feature.

By Elizabeth Thomas Dold

Elizabeth Thomas Dold is a principal attorney at Groom Law Group, chartered in Washington, D.C. For over 15 years, her work has focused on employee benefits and compensation matters, including employment taxes and related reporting and withholding requirements. She regularly advises Fortune 500 companies (including corporate and tax-exempt employers, financial institutions, and third party administrators) on plan qualification and employment tax issues. Ms. Dold is the Chair of the Information Reporting Program Advisory Committee (IRPAC) and a member of the American Society of Pension Professionals and Actuaries (ASPPA). She is an editorial contributor for the "Employee Benefits Corner" in *Taxes*, a CCH publication, and a former adjunct professor at Georgetown Law Center.

Summary of Prior Law

A participant is permitted to make salary deferral contributions under a 401(k) or 403(b) plan as after-tax Roth contributions to a designated Roth account. This provision, enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), was initially effective in 2006, and all participants, regardless of income, are eligible to make these deferrals. These Roth contributions combined with pre-tax deferrals are subject to an annual limit under Code Section 402(g), which is $16,500 for 2011. The investment growth of Roth accounts is never taxed, provided that the ultimate distribution from the plan constitutes a "qualified distribution." In general, the contributions must be held in the account for at least five years and the participant must have reached age 59½, died, or become disabled in order for the distribution to be qualified. However, employer contributions (e.g., matching and profit sharing contributions) were not eligible for Roth treatment, nor could they be converted to a designated Roth account inside the qualified plan.

Under prior law, the only way to convert employer contributions into a Roth account was via rollover to a Roth IRA. Beginning in 2008, all qualified plans were required to permit direct rollovers of non-Roth amounts in the plan to a Roth IRA. The rollover resulted in taxable income to the participant/beneficiary (except to the extent of distribution of after-tax contributions), and income limits and filing status restrictions were imposed on such rollovers. However, in 2010, these restrictions were eliminated; and for 2010 for in-plan Roth rollovers only, a participant/beneficiary could claim the resulting taxable income in two equal installments in 2011 and 2012. Moreover, the 10 percent early distribution tax does not apply to rollovers to a Roth IRA. All of these changes made it attractive for participants/beneficiaries to consider taking distributions from their retirement plan.

Understanding these incentives, various groups urged Congress to allow 401(k) and 403(b) plans to offer this same conversion option without forcing participants to remove the funds from their employers' plans to prevent a leakage of plan assets and loss of ERISA protections. The Act adopts such a provision, effective after September 27, 2010.

Summary of the Roth "In-Plan" Rollover Features

An overview of the new "in-plan" rollover feature is set forth below, along with important guidance from IRS Notice 2010-84 and the November 26, 2010, IRS Employee Plans Newsletter that summarizes the rules and the available guidance.

It is important to note that, although the statute refers to this provision as a "rollover," the funds are not really moving from the plan to another plan, which is normally the case in a rollover. In the in-plan rollover, the funds are rolling over from one type of account to another. Nonetheless, the effect is that of distributing the funds from the pre-tax account (which necessitates a distributable event) and then depositing those funds into the after-tax Roth account, as if it were "rolled over."

Optional provision. The Roth in-plan rollover is a distribution after September 27, 2010, from an individual's plan account that is rolled over to the individual's designated Roth account in the same plan. The Roth "in-plan" rollover feature is optional and can be added to an eligible plan via plan amendment.

Types of plans covered. As discussed, this feature is limited to 401(k) plans, 403(b) plans, and beginning in 2011, governmental 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). Moreover, in order to add this feature, the plan must permit participants to make salary deferrals to a designated Roth account. Plans cannot simply add the rollover feature without allowing participants to make after-tax salary deferrals to a Roth account, and the salary deferral feature must be in place at the time the rollover is first offered.

Amounts eligible for rollover. The rollover extends to all vested amounts in the plan that are eligible for distribution and constitute an eligible rollover distribution. For an active employee who has not yet reached age 59½, the rollover feature will not be available for pre-tax deferrals, as these amounts would not be currently distributable; however, the plan may provide for distribution and rollover of certain employer contributions. Moreover, the following distributions will not be eligible for rollover because they are not eligible rollover distributions:

- Hardship distributions,
- Required minimum distribution ("RMD") payments,
- Lifetime payments,
- Installment payments of 10 years or more, and
- Certain corrective distributions.

Importantly, a plan may be amended to add the in-plan Roth rollover option for amounts the Code permits to be distributed. For example, if the plan does not currently permit in-service distributions of pre-tax deferrals by a participant who has reached age 59½, the plan can be amended to permit such distribution. An employer can amend the plan to permit certain in-service distributions generally, or may limit the distributions to in-plan Roth rollovers, thereby avoiding leakage of funds from the plan.

Eligible participants and beneficiaries. The feature is available to any participant (including an active or former participant with an account balance in the plan), alternate payee that is a spouse or former spouse, and surviving spouse beneficiary who is eligible to receive an eligible rollover distribution from the plan. Importantly, the feature does not extend to nonspouse beneficiaries; they can only elect a rollover to an inherited traditional or Roth IRA.

Direct or indirect rollover. The rollover is made through a direct or indirect rollover. With a direct rollover, no actual distribution occurs; the accounts are transferred within the plan. The direct rollover is not treated as a distribution for the following purposes: (1) no spousal consent is required, (2) a plan loan transferred in the rollover without changing the repayment schedule is not treated as a new loan, (3) notice of the participant's right to defer receipt of the distribution (IRC § 411(a)(11)) is not required, (4) the amount rolled over continues to be taken into account for purposes of determining whether the participant's total accrued benefit exceeds $5,000 under the automatic cash-out rules, and (5) any distribution right before the rollover cannot be eliminated.

For an indirect rollover, all the regular distribution rules apply (including 20 percent withholding), and the participant/spousal beneficiary can elect within 60 days to have the distribution returned to the plan to a designated Roth account. The ability of a terminated employee or a beneficiary to do an indirect rollover can be hampered, however, if the amount distributed is the entire account, as the plan sponsor may elect not to permit the plan to receive rollovers from individuals who are no longer participants or beneficiaries with accounts. As a result, a plan may provide that only direct rollovers to Roth accounts are permitted.

No recharacterization. There is no ability for a participant/beneficiary to later unwind the Roth in-plan rollover once his or her election is made. Unlike rollovers to a Roth IRA, the recharacterization rules of Code Section 408A(d)(6) do not extend to Roth in-plan rollovers.

Summary of Applicable Taxation and Reporting Rules

The taxable amount of the rollover is determined as if the participant/beneficiary elected a rollover to a Roth IRA. The taxable amount is the fair market value of the distribution, reduced by the participant's basis (e.g., after-tax employee contributions). Notably, if the distribution includes employer securities attributable to employee contributions, the fair market value includes any net unrealized appreciation. The fair market value also includes any outstanding loan balance that is rolled over. Additional complexities are outlined below.

Qualified distribution. The key draw of this feature is the ability of participants/beneficiaries to convert non-Roth assets into Roth assets under the current tax rates, and holding those accounts until they are eligible for a "qualified distribution" so that earnings accrued after the rollover date are tax-free (i.e., never subject to federal income tax). Therefore, it is important to determine the requirements for a "qualified distribution." The Code provides that, to have a "qualified distribution," the participant must receive a distribution (1) that is made after a five-year period (generally beginning with the first taxable year in which the participant contributed to a Roth 401(k) account under the plan or under a prior plan that was directly rolled over to the current plan), and (2) made on account of (i) death, (ii) disability, or (iii) after attainment of age 59½. Importantly, it appears that this same five-year period applies to the rolled-over amounts. For example, suppose a 60-year old participant first made a Roth deferral in 2006. On December 18, 2010, the participant makes an in-plan Roth rollover. The participant can take a qualified distribution of the entire amount in 2011.

Special 2010 distribution election. For distributions made in 2010 that are rolled over in a Roth in-plan rollover, the participant has the option to include the taxable amount in gross income in two equal installments in 2011 and 2012, in lieu of electing full taxation for 2010. The election applies to all of the individual's 2010 Roth in-plan rollovers but is independent of the participant's Roth IRA conversion election. This election will be made on Form 8606 by the individual as part of his tax return filing, and does not affect the plan's reporting of the distribution on Form 1099-R. There are complex income acceleration rules set forth in Notice 2010-84 that apply if an individual takes a distribution in 2010 or 2011 before the amount is subject to tax under the special election.

10 percent early distribution tax recapture. Upon subsequent distribution of the rolled over amount within a five-year period—running from the first day of the participant's taxable year in which the rollover was made—the 10 percent early distribution tax (Code § 72(t)) applies as if the rolled over amount were taxable income unless the participant qualifies for an exception from that tax (e.g., the participant is over age 59½). If the distribution is rolled to a Roth IRA or another designated Roth account, the 10 percent tax does not apply (but continues to apply to any subsequent distribution from such Roth IRA or designated Roth account). Notice 2010-84 contains complex rules for computing whether a distribution is subject to the 10 percent tax, particularly during 2010 and 2011. [*See* Notice 2010-84, Q&A-13.]

No 20 percent withholding for direct rollovers. There is no mandatory 20 percent withholding for an in-plan Roth direct rollover. However, the underpayment penalty may arise in the event that the participant/beneficiary does not increase his or her withholdings or make estimated tax payments to account for the conversion. Presumably, the plan sponsor may agree to enter into a voluntary withholding arrangement under Code Section 3402(p) for such direct rollovers, similar to what is permitted for conversions to a Roth IRA. However, for Roth conversions through an indirect rollover, the mandatory 20 percent withholding continues to apply. As noted above, plans may elect not to permit indirect rollovers in this setting.

Reporting. For an in-plan Roth rollover through a direct rollover, the fair market value of the rolled over funds shall be reported on the current year Form 1099-R:

- The gross distribution is reported in Box 1;
- The taxable portion of the rollover (determined as if the amounts were actually distributed) is reported in Box 2a;
- No federal income tax is withheld or reported in Box 4;
- Any basis recovery is reported in Box 5; and
- Code "G" is entered in Box 7 (G4 for a surviving spouse) (these codes reflect a direct rollover/death and indicate that the 10 percent early withdrawal tax does not apply to the rollover).

Importantly, the fact that the participant treats a 2010 in plan Roth rollover as taxable over the two-year period under the special election described above does not impact the Form 1099-R reporting. For indirect rollovers, the Form 1099-R reporting should follow the regular rules. For a direct rollover, if the plan does withholding, report that on a separate Form 1099-R.

Upon a subsequent distribution from the in-plan Roth rollover account, a separate Form 1099-R is used to report the distribution. Moreover, the Form 1099-R must reflect the portion of a distribution from a designated Roth account that is allocable to an in-plan Roth rollover. Specifically, the distribution should be reported the same as any other distribution from a designated Roth account; however, in the blank box to the left of Box 10 (renumbered Box 10 for 2011 Form 1099-R), the amount of the distribution allocable to the in-plan Roth rollover is entered. (The recently released 2011 Form 2011-R provides additional details.)

Action Steps for Adding the Roth "In Plan" Rollover Feature

The following action steps should be considered (and coordinated with the plan's recordkeeper) when adding this new feature:

1. *System Changes to Track the Rollovers and Special Tax Treatment.* The plan's recordkeeping system will need to be modified to track the in-plan rollovers and appropriately report any distributions of such amounts. It appears that a new account can be established to hold these rollovers, or a subaccount under the designated Roth account can be used. Any expansion of the current distribution rights must also be programmed, along with consideration of anticutback and nondiscrimination rules. Moreover, additional changes will be needed if the plan does not already offer Roth deferrals. The five-year period after the rollover must also be tracked to properly apply the Code Section 72(t) 10 percent additional tax.
2. *Plan Amendment.* For a nonsafe harbor 401(k) plan, a plan amendment reflecting the feature must be adopted by the later of December 31, 2011, or the last day of the plan year in which the amendment is effective. For a 401(k) safe harbor plan, the amendment must be adopted by the later of December 31, 2011, or the time specified in Treasury Regulation Section 1.401(k)-3(e)(1) (generally, before the first day of the plan year in which the provision is effective). Lastly, for a 403(b) plan that has a remedial amendment period pursuant to Announcement 2009-89, the amendment must be adopted by the later of the end of such remedial amendment period or the last day of the plan year in which the amendment is effective.
   These deadlines apply to adding (1) the Roth in-plan rollover feature, (2) a Roth 401(k) feature to an existing 401(k) plan (but it doesn't apply if adding a 401(k) feature to the plan), (3) acceptance of rollover contributions by the designated Roth account, and (4) any new distribution right added to the plan with a Roth in-plan direct rollover option.
   The plan, however, must be in operational compliance with the amendment as of the effective date of the amendment. The IRS has not provided any sample plan amendment language to adopt this provision.
   The employer may wish to consider the distribution options that will apply to the in-plan Roth rollover account. For most rollovers, many plans allow in-service distributions at any time. If the plan wishes to avoid leakage, the plan may wish to restrict the ability to withdraw in-plan Roth rollovers (subject to anticutback rules).
3. *Update Distribution Procedures and Participant Notices.* The plan's distribution procedures and notices must be updated to reflect the new feature (including any new distribution rights). Also, participant communications regarding the plan terms need to be updated to reflect these changes without giving tax advice. For example, the 402(f) (rollover) notice must be updated to describe the new feature. Notice 2010-84 includes sample language. Safe harbor 401(k) plans must also update their annual safe harbor notices to reflect the new feature. There are informal indications that the IRS will not require notices for the 2010 and 2011 years to reflect this new provision. Similarly, a "Summary of Material Modification" or "Summary Plan Description" should also describe the new plan feature and any changes in the distribution rights. Moreover, the Form 1099-R reporting and withholding procedures will need to be modified to reflect the special rules described above. ■