investment in stocks increases to $200 because of elimination of the tax liability.

Stocks Increase in Value

Assume that by the deadline for recharacterization, the stocks in my Roth IRA accounts double in value from $200 to $400. By effectively increasing my $100 stock investment to $200 through the Roth conversion, I gained an extra $100, as explained in the next paragraph.

Suppose I had not converted. Ignoring bank account interest, I would have a bank account of $100. My $200 in traditional IRA stock accounts would have doubled in value to $400. Taking into account the Service's 50% ownership, my interest would be worth $200. This $200 plus the $100 bank account results in a total of $300. The conversion made me $100 better off.

If I wished, after the conversion and the increase in stock value, I could balance my investments by shifting one of the $200 Roth IRA stock accounts into a bank account. I would then have a $200 Roth IRA invested in stocks and a $200 Roth IRA in a bank account.

Stocks Decrease in Value

Suppose that by the deadline for recharacterization, the stocks in my Roth IRA accounts *decline* 50%, from $200 to $100. I can then recharacterize my Roth conversion. In effect, I convey back to the Service a 50% interest in my IRA accounts (worth $50) and receive in return the $100 in taxes paid upon conversion. Ignoring bank account interest, my situation is the same as if I had never converted. I have traditional IRAs worth $100 (of which the Service owns 50%) and a $100 bank account.

In short, the opportunity to recharacterize my Roth conversion (by a certain deadline) enables me to invest some money in stocks and enjoy the gains but avoid the losses. If the stock market goes up, I enjoy the gains on $200 worth of stock. If the market goes down, I suffer the losses on only $100 worth of stock. I could even open numerous *separate* Roth IRA accounts in different asset classes. If some accounts appreciate and others depreciate, I can recharacterize the ones that decline.

After recharacterization, I can then *re*convert to a Roth IRA after waiting 30 days or until the tax year following the tax year of the initial Roth IRA conversion, whichever is later. *See* Treas. Reg. §§ 1.408A-5, 1.408A-9.

As before, I hypothesize a constant and uniform income tax rate. Throughout, I also assume that the Congress will not amend the Code to tax distributions from previously created Roth IRAs. ■

In-Plan Roth Conversions

By Scott D. McMillen*

Background

On September 27, 2010, Congress enacted the Small Business Jobs Act of 2010 (Pub. L. No. 111-240) ("the Act"). Sections 2111 through 2112 of the Act contain plan participant friendly provisions for certain types of retirement plans.

Specifically, Section 2112 of the Act amends section 402A, which allows plan participants to make Roth contributions to retirement plans. Newly enacted Act section 2112, at the most fundamental level, allows compatible plans to convert non-Roth contributions into Roth contributions within the existing retirement plan (*i.e.*, without rolling over amounts to a Roth IRA).

The Act's conversion provision was effective immediately for certain retirement plans, but did not come into effect for others (*e.g.*, section 457(b) eligible plans) until the beginning of the 2011 taxable year. However, in order to access the benefits of section 2112, most plans will need to consider and proceed upon a mixture of plan modifications to allow participants the opportunity to utilize the newly enacted provisions. This short article discusses some of the new law's nuances. It also discusses plan sponsor and plan participant considerations for Roth conversions under section 2112.

Mechanics of Conversion

In order to take advantage of the leeway afforded by the Act, a retirement plan must satisfy a number of qualifiers. First, conversion ability is limited to section 401(k), 403(b), and 457(b) plans. Thus, money purchase plans and profit sharing plans without a CODA feature are not eligible for conversion. Second, the plan must allow participants to make Roth contributions. This requires the plan to allow participants to make Roth contributions as a prerequisite before allowing participants to execute a Roth conversion. Third, upon conversion the plan must separately account for the converted pre-tax deferrals within a separate Roth conversion account. Fourth, the conversion is applicable only for amounts that are otherwise considered eligible rollover distributions under the plan. Generally, this means that distributions upon attaining age 59½, upon a separation from service, death, or disability, or that are considered

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qualified reservist distributions are eligible for conversion. Conversely, this does not permit conversion of in-service withdrawals related to hardship. Only amounts that are eligible rollover distributions are eligible for Roth conversion.

Payment of Taxes on Converted Deferrals

One prerequisite for participants completing any conversion of deferrals is paying income taxes on the converted amounts. In order to facilitate conversion, Act section 2112 specifically prevents the 10% excise tax under section 72(t) from applying to converted deferrals. However, beware that the 10% excise tax may apply if converted amounts are withdrawn before the completion of five taxable years. For more information on the applicability of the five-year recapture rule, see Notice 2010-84, 2010-51 I.R.B. 872.

If a participant chose to convert deferrals into Roth contributions in 2010, the default rule is that the associated federal income tax is payable ratably over a two-year period in 2011 and 2012. Thus, the gross income associated with the conversion is not taken into account on the participant's 2010 tax return but is instead taken into account ratably in 2011 and 2012.

It is not clear under the plain meaning of the Code or applicable guidance, but it appears to be a reasonable position, that participants could extinguish the entire tax liability on their 2011 tax return instead of delaying the second half of the obligation to their 2012 returns. Of course, this position would only be practical if a participant could gain an advantage from its applicability. Generally, a participant would rather defer the tax obligation until a future period.

It should be noted that section 2112 of the Act did permit participants to make an election to include the conversion-related gross income on their 2010 tax returns, instead of the default rule of spreading the income ratably over the two-year period. If this election was made, the tax obligation is due with the participant's 2010 tax return, due April 15, 2011 (without regard to any extension). Finally, unlike Roth IRAs, pursuant to section 408A(d)(6), a participant cannot unwind a Roth conversion before the filing of his or her federal income tax return.

Benefits and Deterrents of Conversion

A large benefit of permitting conversions is mitigating the effects of widespread Roth IRA rollovers from retirement plans (so-called leakage). Under current law, the only way for a participant lacking a Roth feature in his existing retirement plan to mimic the tax effects of such a feature, is to engage in a rollover of distributable amounts into a Roth IRA. However, until last year, participants who had adjusted gross income that exceeded $100,000 were barred from engaging in a rollover to a Roth IRA. Congress, now having authorized Roth conversions, will allow retirement plans to mitigate the risk of losing money to Roth rollovers by including this conversion provision within their plan arsenal. This will presumably help preserve any asset-size-related discounts that plan sponsors are able to obtain from recordkeepers or other third-party administrators.

A few distinct advantages remain for participants of distributable age (*e.g.*, 59½) to roll over account balances to Roth IRAs. The first is the most obvious: Roth IRAs generally allow for greater investment control, including the selection of individual equities, along with significant flexibility in modifying investment allocation (*i.e.*, frequency and transparency of trades). Of course, participants come from a wide array of backgrounds and levels of sophistication, and some may not desire to have this type of command over their retirement assets.

Second, a participant may want to execute a rollover to a Roth IRA to seek shelter from the required minimum distribution ("RMD") rules applicable to qualified retirement plans (*e.g.*, 401(k) plans). At this time, even after a Roth conversion has been executed under the Act, amounts in Roth accounts are still subject to the mandatory RMD rules. The RMD rules generally require distribution at the later of retirement or age 70½. Amounts in Roth IRAs are exempt from the mandatory RMD requirements that apply to traditional IRAs and applicable qualified retirement plans. This creates a distinct advantage for Roth IRAs, even where retirement plans have the ability to convert elective deferrals to Roth contributions, because it allows participants to control their timing of asset distribution. Nonetheless, a participant can convert non-Roth accounts into Roth accounts under a qualified retirement plan and still avoid being subject to the RMD requirements. This method is more cumbersome than simply having an exemption from the requirements, but it is just as effective. To correctly avoid application of the RMD scheme, the participant can engage in a Roth conversion under the employer's retirement plan, and then must execute the rollover to a Roth IRA one year before commencing distributions under the RMD rules.

Roth conversions in retirement plans do offer at least one advantage over Roth IRAs. Allowing for Roth conversions in applicable retirement plans allows a participant to have Roth elective deferrals in excess of the IRA limit of $5,000. The participant achieves this result by deferring the maximum Roth limit within a qualified retirement plan, $16,500 (unless the participant is eligible for catch up contributions) and the maximum within a Roth IRA, $5,000 (again, absent catch up contributions).

Service Guidance

On November 26, 2010, the Service released Notice 2010-84, 2010-51 I.R.B. 872. Using a question and answer format, this notice outlined some of the more pressing issues that required guidance before the end of 2010.

Of particular concern for practitioners was the potential remedial amendment period for adopting the obligatory amendments to provide for Roth conversions. Here, the Service indicated that sponsors of 401(k) plans could adopt the conversion amendments by the "later of the last day of the plan year in which the amendment is effective or December 31, 2011." This gives sponsors of 401(k) plans sufficient wiggle room in order to provide for conversions. On the other hand, 403(b) plan sponsors have until the end of their remedial amendment period (to be released by the Service in the near future) or the end of the plan year in the year the amendment is adopted. This will allow 403(b) plan sponsors sufficient time to meet the necessary regulatory requirements to avoid potential qualification errors.

These extensions of time to allow for amendments to meet the requirements of Act section 2112 appear to apply to any plan amendment that is adopted in order to allow for Roth conversions. In Q&A 17 the Service lists the variety of amendments that would qualify, but notes that adding a CODA feature to a qualified plan is not an amendment that relates to compliance with section 2112. Alternatively, amendments to allow Roth elective deferrals, Roth conversion availability, and acceptance of rollover contributions to a Roth account are considered to relate to compliance with Act section 2112 and are thus eligible for the remedial amendment period.

In addition, among the issues addressed was the question of whether or not section 3405(c) and 20% mandatory withholding applies to Roth conversions. Here, the Service indicated that it does not believe it is a requirement for Roth conversion amounts. However, the notice warns that a taxpayer who forgoes withholding risks being subject to an underpayment penalty. Thus, taxpayers should be cognizant of this possibility if they decide to not withhold upon executing a Roth conversion.

The Service also addressed a number of other issues, including proper reporting of conversions on Form 1099-R, notice procedures, application of the five-year recapture rule, and basis allocation under section 72.

The Service is expected to release additional guidance affecting the treatment of Roth conversions. Future guidance may contain more detailed analysis of the rules and should allow plan sponsors greater comfort in implementing conversions.

Section 2111 and 457(b) Government Plans

It is also worth noting that Act section 2111 amends section 402A(e)(1) applicable to section 457(b) eligible plans. This amendment to section 457(b) eligible plans permits plan participants to make Roth contributions. Unlike the Roth conversion rules detailed above, this newly enacted provision did not apply until taxable years beginning after December 31, 2010. After enactment of Act section 2111, government plan participants have equivalent rights in comparison to private sector plan participants, who have had access to Roth contributions for a number of years.

Furthermore, this provision is a revenue producer for the government, with projected benefits exceeding $500 million over a 10-year period according to a summary produced by the Senate Finance Committee. Setting aside revenue projections, this is a provision that has been long awaited by many government employees, and will likely see significant activity in government plans in the foreseeable future. However, this legislation will require 457(b) plans and their record keepers to make a variety of changes going forward. Those changes are beyond the scope of this article.

Conclusion

Congress could have pushed the legislation further to allow for Roth conversions at any point in time, including before a distributable event. This would have quelled fears that plan sponsors would terminate their 401(k) plans to move currently undistributable funds into Roth IRAs. It would also have allowed Roth conversions to become more equivalent to Roth IRAs, which currently have several advantages over Roth conversions (particularly exemption from the RMD rules). Nonetheless, this appears to be a solid start, allowing plan sponsors greater latitude within their existing plans to please participants and close the flood-gate of rollovers to Roth IRAs. ■