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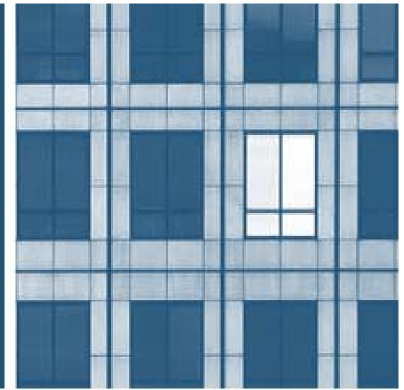
On the Subject



Employee Benefits

October 5, 2010

Employers sponsoring 401(k) or 403(b) plans should give immediate consideration to recently enacted legislation that allows participants to convert their retirement accounts in such plans to Roth accounts in 2010 and avoid some of the plan sponsor concerns that existed under prior law. With a potential increase in individual income tax rates looming in 2011, plan sponsors may be under pressure from executives and other plan participants to permit such conversions prior to the end of the year.

New Law OKs "In-Plan" Roth 401(k) Conversions; Year-End Action May Be Desirable

Background

On September 27, 2010, President Obama signed into law the Small Business Jobs Act of 2010. The new law permits 401(k) and 403(b) plan sponsors to amend their plans to permit vested account balances that can be distributed as an eligible rollover distribution to be converted to Roth amounts within the plan. Converted amounts are treated as distributions and taxable in the year of conversion. However, a special rule permits amounts converted in 2010 to be recognized as income over a two-year period starting in 2011, unless the participant elects to have the income recognized in 2010.

Prior to the new law, a participant could take a distribution of retirement plan assets (to the extent permitted under law and by the plan) and convert the assets outside the plan by rolling over the distribution to a Roth IRA. The prior law put plan sponsors in somewhat of a dilemma because if they wanted to allow participants to maximize the amount of money they could roll over to a Roth IRA, the plan had to expand its in-service distribution features. However, if the plan expanded its in-service distribution features, then those features would need to be offered to a non-discriminatory cross-section of participants—and some of the participants might use a distribution for a purpose other than Roth conversions. This concern about "leakage" from the retirement system caused many plan sponsors to refrain from expanding their in-service distribution options.

The new law fixes the "leakage" problem. Specifically, the legislative history of the new law states that a plan can restrict its expanded in-service distribution options solely to Roth conversions. In other words, a plan can be amended to permit expanded in-service distributions *solely* for the purpose of making in-plan Roth conversions. Now, if the plan permits, a participant or beneficiary eligible to take an in-service distribution may elect to convert plan assets into Roth amounts and keep the assets in the plan. As a result, plan sponsors that were considering amending in-service distribution rules to permit participants to roll over accounts to Roth IRAs to take advantage of 2010 tax rules can now amend their plans to liberalize in-service distribution rules solely for purposes of converting plan assets into Roth assets inside the plan.

Requirements for In-Plan Roth Conversions

A plan may (but is not required to) permit in-plan Roth conversions only if the plan is a 401(k) or 403(b) plan that has a Roth elective deferral arrangement. So, for example, a plan that is only a profit sharing plan would not be eligible to offer in-plan Roth conversions.

If a plan permits Roth conversions, a participant can only convert amounts that are otherwise distributable under the terms of the plan (as amended) and qualify as eligible rollover distributions. Under the Internal Revenue Code, the maximum extent to which in-service distributions are permissible depends on the type of contribution:

- Participant 401(k) deferrals are generally distributable only upon the participant's severance from employment, death, disability or attainment of age 59½.
- Employer matching and profit sharing contributions generally can be distributed while a participant is actively employed if the employer contributions have accumulated for a fixed number of years, upon the attainment of a stated age or upon

any other stated event. Internal Revenue Service (IRS) rulings have clarified that the "fixed number of years" generally must be at least two years, but that a plan can permit a full distribution of all employer contributions after a participant has participated in the plan for a period of at least five years. These "two-year/five-year" rules are commonly accepted as the most liberal rules a plan can permit for in-service distribution of employer matching and profit sharing contributions.

- After-tax and rollover contributions are generally freely distributable at any time.

Plan sponsors may amend their plans to permit in-plan Roth conversions for some or all of these types of contributions.

Benefits to Participants

The ability to convert plan assets into Roth assets may be popular with plan participants because they can choose to convert plan assets into Roth assets and later take a tax-free distribution, provided the participant meets the requirements for a qualified Roth distribution. Participants who are unsure about future tax rates or their future tax bracket can diversify by converting some retirement plan assets into Roth assets and maintaining other assets as traditional pre-tax assets.

Conversion may be particularly advantageous for participants in 2010. As noted above, a special rule allows individuals to delay recognition of 2010 income until 2011 and 2012 for a Roth conversion. On the other hand, tax rates are currently scheduled to increase after 2010 (the top marginal tax rate is scheduled to increase from 35 percent to 39.6 percent), so participants may choose to do a conversion in 2010 but elect not to defer recognition of the converted amount.

Converted amounts are not subject to the 10 percent early distribution tax under Section 72(t) of the Internal Revenue Code (generally applicable to distributions to participants under age 59½ that are not rolled over to an IRA).

Challenges and Steps for Plan Sponsors

Plan sponsors may want to permit in-plan Roth conversions in 2010 to help participants take advantage of favorable tax laws. However, a number of issues remain unclear and adoption of in-plan Roth conversions in 2010 may prove challenging.

The most pressing question will be whether plan administrators can handle conversions in 2010. If in-plan conversions can be administered, decisions will need to be made on how a participant can make an election, which plan assets can be converted, how frequently conversions can be made and whether there is a minimum amount that can be converted at a given time. Plan administrators and service providers will need to develop systems and forms to permit elections and track and report conversions. Administrators will need to develop participant notices and communications. Sponsors of plans that do not currently permit Roth contributions will need to consider whether they can establish a Roth elective deferral feature in their plan before the end of 2010 in order to simultaneously implement in-plan Roth conversions.

A number of other administrative issues related to in-plan Roth conversions are unclear:

- It is not clear whether converted amounts will be subject to mandatory withholding by an employer or how in-plan conversions will be reported. Under current law, rollovers to Roth IRAs are not subject to withholding requirements, although the participant and the employer may enter into a voluntary withholding arrangement.

- For participants with outstanding loans, it is not clear whether loan balances can be converted.

- For plans that permit participants to hold assets in employer securities it is not clear if the favorable tax treatment of net unrealized appreciation can apply to converted distributions that otherwise qualify for such treatment. Guidance on these and other issues may not be issued until after 2010.

The legislative history of the new law states that it is intended that the IRS provide employers with a remedial amendment period that allows them a sufficient period of time to amend their plans to reflect the in-plan Roth conversion options. It is unclear how the IRS will interpret this remedial amendment period, but action may still be desirable before year-end to document any new Roth feature or any expanded distribution rights that are added to the plan.

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