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In-Plan Roth Conversions

Section 401(k) and 403(b) plan sponsors may now allow certain participants to convert their accounts held under the plan to Roth accounts. This in-plan conversion will allow participants to include these amounts in gross income for federal tax purposes in the year of the conversion, rather than having to wait until the year in which the amounts are actually distributed from the plan. Previously, a participant who wanted to convert his or her account to a Roth account would have had to take a distribution from the plan and then roll the distribution over to another plan with a Roth feature, such as a Roth IRA, in order to accelerate taxation and allow future earnings to accumulate tax-free.

ALLOWABLE PLANS

Section 401(k) and 403(b) plans may allow certain participants to convert their vested accounts to Roth accounts within the plan. This conversion may be accomplished via a direct rollover within the plan to the Roth account or via an indirect rollover, whereby a participant receives a distribution from the plan and then rolls it over back into the plan within 60 days.

The plan must have a designated Roth program in place whereby participants can periodically make designated Roth contributions to the plan. A plan cannot set up Roth accounts solely to accept in-plan conversions. A Roth contribution program will be deemed to be in place on a given date if employees are given an opportunity as of that date to elect to have Roth contributions made to the plan.

Plans that do not have designated Roth contribution programs (such as defined benefit or Non-401(k) Profit Sharing Plans) may neither accept Roth rollovers, nor perform an in-plan Roth conversion.

ONLY ELIGIBLE ROLLOVER AMOUNTS MAY BE CONVERTED

In-plan conversions can only be made in connection with amounts that are eligible to be rolled over pursuant to the terms of the plan and the Internal Revenue Code (Code).

- In terms of Code-based limitations, pretax elective deferrals cannot be rolled over unless the participant is age 59-½ or older or is disabled, has terminated employment, or is eligible for a qualified reservist distribution. In addition, amounts that cannot otherwise be rolled over to another eligible retirement plan—such as required minimum distributions, hardship distributions, corrective distributions of excess deferrals, deemed distributions, and dividends from employer securities—cannot be converted. A beneficiary may elect an in-plan conversion only if he or she is a surviving spouse and an alternate payee may elect it only if he or she is a spouse or former spouse, provided that in both cases the individual has the right to take a distribution from the plan.

- In terms of plan-based limits, a plan's distribution and withdrawal provisions must permit the participant to take a distribution or a withdrawal. However, a plan can offer an in-plan Roth conversion feature without allowing participants to take an actual distribution from the Plan. For example, the match or profit sharing balance can be convertible because the participant has reached normal retirement age, but not truly distribute-able because the plan may require the employee to have stopped working (actually retired) to be eligible for a distribution. This feature provides a potentially valuable planning opportunity to plan sponsors with plans that provide employer non-elective and/or matching contributions, as, due to the Code-based limitations that apply to pre-tax elective deferrals, there is little else that a plan sponsor can do in the way of expanding in-plan Roth conversion opportunities for pre-tax elective deferrals.

TAXATION APPLICABLE TO CONVERSION

The amount includable in gross income as a result of an in-plan conversion is the fair market value of the distribution, reduced by any basis that the participant may have in the distribution. If the amounts converted include an outstanding participant loan, the loan balance will be includable in gross income. If the distribution includes employer securities attributable to employee contributions, any net unrealized appreciation will be included in the fair market value. The conversion will not be subject to federal income tax withholding. Because of this, participants may need to increase their withholding rate on wages or make estimated tax payments in order to avoid being subject to an underpayment penalty.

SPECIAL TAXATION RULE FOR 2010

The in-plan conversion will generally be subject to tax in the year of conversion. However, for 2010 only, amounts converted to a Roth account (either within a plan or via a rollover to a Roth IRA) in 2010 will not be taxed in 2010 unless the participant so elects. Instead, the taxable income will be split between 2011 and 2012 and will be taxed at the rate applicable for the relevant year.

A ROTH CONVERSION NOT TREATED AS A DISTRIBUTION FOR MOST PURPOSES

An In-Plan Conversion is generally deemed only to change the tax character of the relevant amounts and the accounts under which they are held. If a plan loan is part of the conversion, the loan will not be treated as a new loan, so that the repayment schedule will remain the same. The conversion will not be treated as a distribution, so that it will not be subject to the spousal consent rules. The converted amount continues to be taken into account in determining whether the participant's account balance exceeds the mandatory cash-out limit of $5,000, and a participant's right to any optional distribution forms stated in the plan will continue to attach to the amounts converted.

SUBSEQUENT DISTRIBUTIONS

If a distribution is made from an in-plan conversion account within the five-taxable-year period beginning on the first day of the tax year in which the conversion was made, the amount distributed, to the extent allocable to the converted amount, will generally be subject to the 10% early withdrawal penalty unless an exception (e.g., death, disability, attainment of age 59-½) applies.

PLAN AMENDMENTS

Generally, a plan amendment to make a discretionary change, such as the addition of an In-plan conversion feature, would need to be adopted by the end of the plan year in which the change is effective. Therefore, the in-plan Conversion can take place before the plan is amended. But, be careful; if only a select group of employees is given the opportunity to make a conversion, this could be discriminatory. The best practice is to amend the plan and notify all participants of the new feature asap.

A description of the in-plan conversion feature must be included in the special tax notice provided to participants in connection with a distribution request pursuant to Section 402(f) of the Code. Participants electing a conversion do not need to be provided with a notice of their right to defer receipt of the distribution, however, since the conversion is not treated as a distribution for this purpose.

BACKGROUND ON A DESIGNATED ROTH FEATURE

Under a 401(k) or 403(b) plan's Roth feature, participants may make elective contributions to the plan that are taxed immediately. In return, "qualified" distributions of these amounts, including earnings, will not be subject to federal income tax if certain conditions are met. In order for a distribution of designated Roth contributions to be qualified, it must be made (i) after a five-year period of Roth participation and (ii) after either the participant's attainment of age 59-½ or his or her death or disability. The five-year period of Roth participation generally begins on January 1 of the year in which the participant first makes a Roth contribution under the plan. If amounts have been directly rolled over into the plan from another 401(k) or 403(b) plan with a designated Roth program, however, the five-year period may include the Roth participation period under the other plan, if it began earlier.

If a distribution is not a qualified distribution, the portion of the distribution attributable to accumulated income on the designated Roth contributions is includable in the participant's gross income for federal income tax purposes. In addition, if the distribution is made prior to the expiration of the five-year period of Roth participation, the taxable earnings included in the distribution could be subject to the 10% penalty on early distributions (unless an exception applies).

Other than these special taxation rules, designated Roth contributions are generally subject to the same rules that apply to pre-tax deferrals. This means that designated Roth contributions must be 100% vested when made, are subject to the average deferral percentage (ADP) test, and can only be distributed upon the employee's attainment of age 59-½, death, disability, hardship, or severance from employment, or the termination of the plan. Designated Roth contributions may be treated as catch-up contributions and serve as the basis for a participant loan. Participants must be allowed to change their designated Roth contribution elections at least once a year, and participants may automatically be enrolled in a designated Roth contribution program, provided the plan specifies the portion of the automatic deferral that will be treated as pre-tax and the portion that will be treated as a Roth contribution.

A plan may treat the portion holding designated Roth contributions as a separate plan for purposes of applying the automatic rollover rules applicable to mandatory distributions in excess of $1,000 and for determining whether a direct rollover request may be denied because it does not meet the minimum balance requirement (which may be applied to amounts that total less than $200). Roth contributions and related earnings must be maintained in a separate account. Designated Roth accounts may only be rolled over tax-free to another designated Roth account under an employer's plan or to a Roth IRA.

CONCLUSION

The in-plan Roth conversion rules allow Section 401(k) and 403(b) (and ultimately, 457(b)) plan sponsors to offer participants more flexibility in their retirement tax planning.

Reference: Internal Revenue Service (IRS) Notice 2010-84