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In-Plan Roth Conversion Rules Fleshed Out by Recent IRS Guidance

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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 (subject to a special rule for 2010 conversions), 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. This change, which was made by the Small Business Jobs Act of 2010 (Act) effective for distributions made after September 27, 2010, allows eligible participants to convert their qualified plan or 403(b) accounts to Roth accounts without taking a distribution from the plan.

Although the Act allows in-plan Roth conversions, it does not address the nuts and bolts of how the conversion feature works in operation. Internal Revenue Service (IRS) Notice 2010-84 (Notice), issued November 26, 2010, fills in many of these gaps.

Currently, only Section 401(k) and 403(b) plans may include a Roth feature. For taxable years beginning after 2010, however, Section 457(b) plans maintained by a state, a political subdivision of a state, an agency or instrumentality of a state, or an agency or instrumentality of a political subdivision of a state may add a designated Roth feature.

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 59½ 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 59½, 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.

In-Plan Conversions

Effective on and after September 28, 2010, 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, so long as the distribution was made after September 27, 2010.

Plan Must Have a Designated Roth Program

In order to allow in-plan conversions, 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.

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, pre-tax elective deferrals cannot be rolled over unless the participant is age 59½ 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, the Act and the Notice make it clear that a plan can offer an in-plan Roth conversion feature without allowing participants to take an actual distribution from the Plan. This feature provides a potentially valuable planning opportunity to plan sponsors with plans that provide employer nonelective 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.

  In addition, before the Act, plan sponsors that were interested in providing Roth conversion opportunities for employer nonelective and/or employer-matching contributions were reluctant to provide participants with broad withdrawal rights for their accounts for fear that participants would simply take a withdrawal and not follow through with the Roth conversion. Now, under the Act, a plan sponsor can offer an in-plan Roth conversion opportunity for employer nonelective and/or matching contributions (subject to the Code-based distribution restrictions applicable to these types of contributions) without providing participants with the opportunity to actually take a withdrawal from the plan. As such, plan sponsors should evaluate their plans' distribution and withdrawal provisions to determine whether it is desirable to make changes in order to expand in-plan Roth conversion opportunities.

Taxation Applicable to Conversion; Special Rule for 2010

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.

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. It is important to note that while the income will be split evenly between the two years, the actual tax may vary depending on the tax rates that are in effect for these years. If income tax is deferred to 2011 and 2012 on an in-plan Roth conversion and a distribution is subsequently taken from these amounts in either 2010 or 2011, income tax that initially was to be deferred to 2011 or 2012 may be accelerated to the year of distribution.

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 59½) applies.

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. This means that 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.

Plan Amendments

Generally, a plan amendment to make a discretionary change, such as the addition of an in-plan Roth conversion feature, would need to be adopted by the end of the plan year in which the change is effective. However, the IRS has provided an extension of time to adopt Roth conversion amendments. The time for amending a non-safe harbor Section 401(k) plan is extended to the later of (i) the last day of the plan year in which the conversion feature was added or (ii) December 31, 2011. A safe harbor Section 401(k) plan must generally be amended by the later of (i) the *first* day of the plan year in which the conversion feature was added or (ii) December 31, 2011.

The amendment deadline for a Section 403(b) plan depends on whether the plan will be subject to an extended "remedial amendment period." A Section 403(b) plan will be subject to an extended remedial amendment period only if it adopts a plan that is pre-approved by the IRS (such as a prototype plan) or applies for an individual determination letter from the IRS. The IRS does not currently have a program whereby Section 403(b) plans can be pre-approved or receive individual determination letters, but it plans to open such programs in the near future. If the Section 403(b) plan is subject to the extended remedial amendment period, the amendment deadline will be the later of (i) the end of the remedial amendment period or (ii) the last day of the plan year in which the conversion feature was added. If this remedial amendment period is not available to the Section 403(b) plan, the amendment will need to be adopted by the last day of the plan year in which the conversion feature is added.

This extension applies to amendments to add the in-plan conversion feature, to add a distribution option to the plan in connection with the conversion, or to permit elective deferrals to be designated as Roth contributions. However, the extension does not apply to an amendment to add a Section 401(k) cash or deferred arrangement to the plan.

Notices

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.

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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. Section 401(k) and 403(b) plan sponsors that want to allow participants to take advantage of the special 2010 tax-deferral rules, however, may find it difficult to institute the necessary changes to accommodate in-plan Roth conversions by the end of the year.

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