

employee benefits lawflash

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Fiscal Cliff Legislation Expands In-Plan Roth Conversion Opportunities

American Taxpayer Relief Act extends the existing, limited in-plan Roth conversion option to all amounts under plans that allow elective deferrals, including those amounts not yet eligible for distribution.

The American Taxpayer Relief Act (ATRA), H.R. 8, which gained final approval from Congress on January 1, 2013, and was signed into law by President Barack Obama on January 2, 2013, expands section 402A(c)(4) of the Internal Revenue Code of 1986, as amended (the Code), by extending the existing, limited in-plan Roth conversion option to all amounts under plans that allow elective deferrals, such as 401(k) plans, including those amounts not yet eligible for distribution. The new rule applies to in-plan Roth conversions in taxable years after December 31, 2012. Plan sponsors should take this opportunity to consider possible amendments to their plan to add or expand an in-plan Roth conversion feature.

What Is an In-Plan Roth Conversion?

If permitted under the terms of the plan, participants of a 401(k) plan, 403(b) plan, or governmental 457(b) plan may elect an "in-plan Roth conversion" in which they transfer assets from their non-Roth accounts to a designated Roth account in the same plan. An in-plan Roth conversion of non-Roth pretax dollars to Roth after-tax dollars causes the converted amounts to be taxed in the year of the conversion, while generally allowing for future qualified tax-free distributions of converted amounts and any accumulated earnings, so long as the account has been in place for at least five years and the distribution satisfies certain other restrictions.

Prior Rule

In-plan Roth conversions were permitted on a more limited basis prior to the passage of ATRA. Under the prior rules, conversions were limited to amounts that were otherwise distributable under tax law and the terms of the plan. This meant that participants were generally limited to converting (1) funds that the participant had rolled over from a prior plan, (2) employer contributions that could be withdrawn, or (3) pretax elective deferrals that the participant could withdraw upon reaching age 59½. Active participants could not convert pretax elective deferrals prior to attaining age 59½, for example, or employer contributions that had not been held in the plan for the required number of years. This limited the pool of potential assets that were eligible for in-plan Roth conversion.

New Rule

Under ATRA, beginning in 2013, eligible plans that include an in-plan Roth contribution feature may offer participants the option of converting *any* amounts held in the plan to after-tax Roth, regardless of whether those amounts are currently distributable. In other words, all vested assets in an eligible plan may now be converted, including pretax elective deferrals, employer-matching contributions, and nonelective employer contributions.

Impact and Next Steps

By broadening the pool of eligible assets, the new rule will enable plan sponsors to provide participants with a much greater opportunity to convert pretax dollars to Roth after-tax dollars. This may be especially attractive for

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those individuals in lower tax brackets who have assets outside of the plan that can be used to pay taxes on the conversion.

Beginning in 2013, plan sponsors will have the option, but not the obligation, to amend their eligible plans to add or expand the in-plan Roth conversion feature. The new rule is permissive rather than mandatory and will therefore require a plan amendment to be effective. A plan is not required to offer the expanded option, for example, simply because it already offers an in-plan Roth conversion feature permitted under pre-ATRA rules.

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