

## employee benefits lawflash

December 18, 2013

## IRS Issues Notice on Expanded In-Plan Roth Conversion Option

*Guidance confirms that plan sponsors have flexibility in designing and implementing a feature that allows participants to convert vested pre-tax balances to after-tax Roth balances.*

On December 11, the Internal Revenue Service (IRS) issued Notice 2013-74<sup>1</sup> to provide guidance on a change in law that permits sponsors of 401(k), 403(b), and governmental 457(b) plans to offer participants in-plan Roth conversions of pre-tax amounts not yet eligible for distribution. The change, enacted early in 2013 as part of the American Taxpayer Relief Act (ATRA),<sup>2</sup> expanded section 402A(c)(4) of the Internal Revenue Code of 1986, as amended, (the Code) by extending an existing, limited in-plan Roth conversion option to all vested amounts under eligible plans, including those amounts not yet eligible for distribution.

Notice 2013-74 confirms that plan sponsors that implement an in-plan Roth conversion option generally may limit the types of vested pre-tax contributions that participants can convert, may specify the frequency with which participants can elect to make in-plan conversions, and may discontinue such in-plan conversion programs. The notice further provides special time frames during which plan sponsors may adopt amendments related to in-plan Roth conversion features as well as other guidance regarding in-plan Roth conversions of both distributable and nondistributable amounts.

### What is an in-plan Roth conversion?

Sponsors of 401(k) plans, 403(b) plans, and governmental 457(b) plans may offer participants the option to make in-plan Roth conversions (referred to as “in-plan Roth rollovers” in Notice 2013-74), 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 pre-tax 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.

### Which pre-tax amounts can be converted to Roth after-tax amounts?

All vested assets in an eligible plan may now be converted under a plan’s in-plan Roth conversion feature, including pre-tax elective deferrals, employer matching contributions, and nonelective employer contributions. Prior to the change in law under ATRA, the in-plan Roth conversion option was limited to amounts that were otherwise distributable under tax law. ATRA extended the in-plan Roth conversion option to amounts not otherwise distributable from a plan. Notice 2013-74 clarifies that only vested amounts may be converted.

Notice 2013-74 also makes clear that plan sponsors may restrict the types of vested contributions eligible for an in-plan Roth conversion and the frequency with which participants can make in-plan Roth conversions, provided

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1. View Notice 2013-74 at <http://www.irs.gov/pub/irs-drop/n-13-74.pdf>.

2. For more information on this change under ATRA, view our January 30, 2013 LawFlash, “Fiscal Cliff Legislation Expands In-Plan Roth Conversion Opportunities,” available at [https://www.morganlewis.com/pubs/EB\\_LF\\_LegislationExpandsRothConversionOpportunities\\_30Jan13](https://www.morganlewis.com/pubs/EB_LF_LegislationExpandsRothConversionOpportunities_30Jan13).

that such restrictions do not operate to discriminate in favor of highly compensated employees. The notice also explains that the right to make in-plan Roth conversions is not a protected benefit and thus can be discontinued subject to the general nondiscrimination rules.

## What guidance does Notice 2013-74 offer on the administration of in-plan Roth conversions?

### Withholding and Tax Consequences

Notice 2013-74 provides that amounts converted under an in-plan Roth conversion option are not subject to income tax withholding and accordingly warns that employees who make in-plan Roth conversions may need to increase their withholding rates or make estimated tax payments to cover the income tax liability resulting from the conversion. For plan accounts holding employer securities, the notice indicates that an in-plan Roth conversion will be treated as a distribution for the purpose of determining whether a participant qualifies for special tax treatment of the net unrealized appreciation on employer securities under Code section 402(e)(4)(B).

Although the IRS characterizes in-plan Roth conversions as in-plan “rollovers” from non-Roth to Roth accounts, Notice 2013-74 explains that plan administrators do not need to provide Code section 402(f) notices regarding the tax consequences of rollover distributions to employees who elect to make in-plan Roth conversions of otherwise nondistributable amounts.

### Maintenance of Distribution Restrictions

The notice also explains that distribution restrictions applying to a pre-tax amount before it is converted to a Roth after-tax amount under an in-plan Roth conversion feature will continue to apply to the converted amount. The notice acknowledges that, to simplify recordkeeping, a plan sponsor may wish to restrict eligibility for in-plan Roth conversion only to otherwise distributable amounts so that separate accounting for different converted amounts, subject to different distribution restrictions, is not required.

### Determination of the Five-Year Period for Qualified Roth Distributions

Distributions of Roth amounts and accumulated earnings ordinarily are tax free if they are “qualified distributions” from a Roth account made more than five taxable years after the first year the participant contributed to the Roth account and if they satisfy certain other restrictions. For the purpose of determining when a subsequent distribution is “qualified,” Notice 2013-74 confirms that, if an in-plan Roth conversion is a participant’s first contribution to a designated Roth account in the plan, the five-taxable-year period begins on the first day of the taxable year in which the in-plan Roth conversion was made.

### Treatment of Converted Excess Deferrals and Contributions

The notice provides further guidance on the treatment of amounts converted under an in-plan Roth conversion feature that are later found to be excess deferrals under the Code’s individual deferral limits or excess contributions under the Code’s nondiscrimination rules. The notice explains that, if an employee converts all pre-tax amounts to Roth after-tax amounts through an in-plan Roth conversion feature and the amounts are later found to be excess deferrals or contributions, the excess amounts must be distributed from the Roth account even if the amounts were considered otherwise nondistributable at the time of the in-plan Roth conversion.

### Effect on Determination of Top-Heavy Status

The notice provides that an amount converted in an in-plan Roth conversion (which the notice refers to as an “in-plan Roth rollover”) is treated as a “related rollover” amount that is considered in calculating participant account balances under the rules for determining whether a plan is a “top heavy” plan that favors key employees.

## When must a plan sponsor adopt an amendment providing for in-plan Roth conversions of otherwise distributable amounts?

Under Notice 2013-74, a 401(k) plan or governmental 457(b) plan generally can immediately begin offering in-plan Roth conversions, provided that a plan amendment for the in-plan Roth conversion feature is adopted by the last day of the first plan year in which the amendment is effective or December 31, 2014, if later. The notice also permits sponsors of safe harbor 401(k) plans to begin immediately offering such conversions, even midyear, in 2013 and 2014. For a calendar-year safe-harbor plan, the amendment to provide the conversion option starting midyear 2013 or 2014 must be adopted by December 31, 2014. A 403(b) plan sponsor that has timely adopted a written plan document may offer in-plan Roth conversions immediately as well and must adopt an amendment by the end of the ongoing remedial amendment period. The notice indicates that the IRS expects the end of the 403(b) plan remedial amendment period to be more than a year from the date of the notice.

This special amendment period applies to the implementation of in-plan Roth conversion features of both distributable and otherwise not distributable amounts as well as to the addition of Roth contribution features and provisions to accept Roth rollover contributions.

## What are the impacts and what next steps should plan sponsors take?

By broadening the pool of eligible assets, the new in-plan Roth conversion rule provides participants with a much greater opportunity to convert pre-tax dollars to Roth after-tax dollars. This is especially attractive for those individuals currently in lower tax brackets who have assets outside of the plan that can be used to pay taxes on the conversion.

Plan sponsors have the option, but not the obligation, to amend their eligible plans to add or expand the in-plan Roth conversion feature. 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 the prior rules or accepts ongoing Roth contributions. Plan sponsors that have adopted or will adopt the feature have the ability to limit the types of contributions eligible for in-plan Roth conversion and to discontinue the conversion program. The new rule is permissive rather than mandatory and will therefore require a plan amendment to be effective. Plan sponsors that already have been offering in-plan Roth deferrals generally will have at least until the end of 2014 to adopt a plan amendment.

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