Jordan & Associates Retirement Services
Technical Comment

In-Plan ROTH Conversions

October 15, 2010

The Small Business Jobs and Credit Act of 2010 was signed into law on September 27, 2010. A provision of this new law allows participants of some qualified plans to convert some "tax-deferred" current plan account balances to an "after-tax" designated ROTH account, creating a tax liability to the participant. The entire ROTH account balance, including investment gains, may then be treated as nontaxable upon its eventual distribution.

Plan document issues:

- Retirement plans are not required to offer In-Plan ROTH conversions.
- If an Employer/Plan Sponsor wishes to offer In-Plan ROTH conversions in their plan, a Plan amendment is required, but "it is intended that" IRS will provide a remedial amendment period so employers can permit conversions in 2010, and then have sufficient time to reflect the provision in the plan language at a later date. The IRS has not yet provided this remedial amendment option, or approved language for adoption. We recommend that In-Plan ROTH conversions be delayed until IRS has commented and provided additional guidance with respect to the process for taxation and reporting of the distribution. IRS comments are expected soon.
- The plan must currently allow participants to elect to defer compensation after-tax, to a ROTH 401(k) salary deferral account. Therefore, it should be noted that ROTH conversions can be made only in a plan with 401(k) provisions, i.e., not in a profit sharing plan without 401(k).
- A participant wishing to convert must have a distributable event that allows the plan to make a distribution, even though the "distribution" will actually remain in the Plan, and the conversion amount must also meet all requirements to be an "eligible rollover distribution." Since regulations don't permit any plan to make an in-service distribution before the participant has reached age 59½ for: 1) amounts resulting from money purchase pension contributions (including pension amounts that were transferred into a profit sharing plan in a manner other than as a participant-directed rollover); 2) amounts resulting from 401(k) salary deferrals; 3) amounts resulting from Safe Harbor contributions, or 4) amounts resulting from QNECs, it appears that these types of plan accounts cannot be converted to ROTH under the new law.
- If the Plan Sponsor wants to make in-plan ROTH conversion available to as many participants as possible, the plan document should be amended to allow in-service distributions of plan amounts resulting from regular employer nonelective (not Safe Harbor nonelective), regular employer matching (not Safe Harbor matching) and employee rollover contributions at any time, and plan amounts resulting from all contribution types only upon reaching age 59½. If desired, the document can be written to say that some or all of these in-service distributions are allowed only for those participants who are converting the "distribution" to a designated ROTH account within the same plan.

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Plan operation issues:

- It doesn't appear that a participant electing a ROTH conversion is required to have ever elected or to be currently electing ROTH 401(k) deferrals.
- A conversion "distribution" will most often be made from plan amounts resulting from contributions other than 401(k) salary deferrals (because of the age 59½ limitation), therefore the transfer within the plan should be made to a new "Designated ROTH" account added to plan recordkeeping for this purpose, rather than being transferred to any existing account in the plan that is meant to receive ROTH 401(k) salary deferrals.
- Only the vested portion of the allowable participant account types may be converted to ROTH.
- If a plan allows In-Plan ROTH conversions, the option must also be available to a spousal beneficiary, assuming the spouse would otherwise be permitted to take a distribution from the plan.
- An In-Plan ROTH conversion amount will normally be taxable to the participant in the year in which the conversion takes place. However, there is a special rule for any conversions that can be completed by 12/31/2010 allowing the participant to elect to defer the taxes that would normally be due for 2010 over the next two years, half in 2011 and half in 2012. This special rule is similar to the tax treatment that applies to conversions to ROTH IRAs in 2010.
- The 10% Federal premature distribution penalty for distributions made prior to age 59½ will not apply to In-Plan ROTH conversions.
- IRS has not yet provided specific guidance on the tax liability reporting process for an In-Plan ROTH conversion, but it seems likely that Form 1099-R codes covering this type of "deemed distribution" will be provided with the 2010 1099-R instructions, expected soon, and that the plan or plan investment custodian will be required to report the conversion amount on Forms 1099-R and 1096. It seems likely that there will be no requirement for tax withholding, since the participant would not receive a cash distribution upon a conversion within the plan. It also seems likely that the participant's election to pay the tax for the year of the conversion or to take advantage of the special rule to defer taxation to 2011 and 2012 (for a 2010 conversion only) will be accomplished on the participant's individual income tax return, rather than as an election at the time the conversion is requested. Additional requirements for State taxation and reporting are unknown at this time.
- It's possible that an investment Custodian (the institution holding the plan assets) that is responsible for distribution reporting and plan recordkeeping may not be prepared for the requirements of the conversion process, and therefore may not immediately accept conversion elections. The ability of the investment Custodian to handle the processing, tax reporting and recordkeeping requirements should be discussed before the plan language or plan operation procedures are changed to allow In-Plan ROTH conversions.