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TCRS 2010-06: IN-PLAN CONVERSIONS TO DESIGNATED ROTH ACCOUNTS

On September 27, 2010, the President signed into law the Small Business Jobs and Credit Act of 2010 ("Act"). The Act permits non-Roth amounts in 401(k), 403(b) and governmental 457(b) plans to be converted to Roth amounts within the same plan effective September 27, 2010 for 401(k) and 403(b) plans, and for tax years beginning after December 31, 2010, for governmental 457(b) plans.

Under prior law, participants could only take advantage of a Roth conversion opportunity by taking their non-Roth amounts out of their employer's plan and rolling them into a Roth IRA. Supporters of Roth conversions noted that this provision increases the opportunity for leakage, exposing participants to higher fees in the retail environment and foregoing the many benefits of staying invested in employer plans, such as fiduciary oversight, higher quality services and lower cost of investments. They also noted that the Roth in-plan conversion feature puts 401(k) and 403(b) plans in parity with IRAs in that participants could convert non-Roth amounts in employer plans into designated Roth accounts under the same plan. The Act permits an employer to amend its 401(k) or 403(b) plan to allow the conversion provided it is made after September 27, 2010 on account of a distributable event under the plan and the conversion meets the rollover requirements.

The Act also permits sponsors of governmental 457(b) plans to add designated Roth accounts to their plans effective for taxable years beginning after December 31, 2010 and then amend their plans to permit the in-plan conversions, if the conversion meets the above requirements that apply to 401(k) and 403(b) plans.

Special Tax Rules for 2010 Conversions

For conversions made during 2010, the taxable amount will be spread 50/50 over taxable years 2011 and 2012, unless the participant elects to include the total converted amount in his/her 2010 federal tax return. According to IRS guidance, the election may not be revoked after the due date, plus extensions for filing such 2010 tax return.

Additional Key Provisions of In-Plan Conversions

- The feature is completely discretionary; there is no requirement to add an in-plan conversion feature.
- The plan must permit ongoing Roth contributions to have the conversion feature.
- The plan document must be amended to add the conversion feature.
- The converting participant must have reached a distributable event under the terms of the plan, e.g. age 59 ½.
- The 10% early distribution tax does not apply to the converted amount.
- In addition to pre-tax deferral amounts, post-tax employee contribution and certain vested employer contribution amounts may also be converted.
- Only eligible rollover distributions may be converted. Hardship withdrawals, minimum distribution amounts and corrective distributions may not be converted as these are not eligible rollover distributions.
- Converted amounts are subject to the plan's minimum distribution rules.
- Spousal beneficiaries are eligible for the conversion.

Plan Amendment Requirement

The IRS has issued partial guidance relating to in-plan Roth conversions. However, the guidance did not address plan amendment requirements. The Joint Committee on Taxation's technical explanation of the Act anticipates that the IRS will provide sufficient time for plan sponsors who choose to allow the in-plan conversion feature to timely adopt the required amendments.

An Important Reminder From The Center – 2010 Conversions Into Roth IRAs

There is still time to convert a Non-Roth IRA into a Roth IRA in 2010. Individuals contemplating whether or not to convert may find the following reasons helpful (the list is not all inclusive):

Reasons to Convert

- Distributions from the Roth IRA are tax-free if distributions are "qualified."¹
- Income tax rates may go up in 2011, if the Bush tax cuts expire this year.
- IRA contribution limits do not apply, so the conversion can be made even though a full IRA contribution was made for the year.
- No income restriction (\$100,000, pre-2010)
- If the conversion is made in 2010, federal taxation of the converted amount may be spread 50/50 during the 2011 and 2012 tax years. After 2010, amounts converted to a Roth IRA will be taxable in the year of conversion.
- Available to married taxpayers, even if filing separately
- Individuals who wish to defer withdrawals from their IRA savings for a period longer than allowed under traditional IRAs because of the minimum distribution rules may benefit from the conversion.
- The conversion allows retired individuals to leave a more substantial bequest to their dependents and heirs.

There are a number of factors that could impact the outcome of a Roth conversion, whether the conversion is in-plan or to a Roth IRA. Taxpayers are encouraged to consult their tax advisor before converting.

¹ A distribution made after the 5-taxable year period beginning with the first taxable year for which a Roth IRA contribution is made and after age 59½, death or disability.

This Summary is designed to provide an overview of the Roth in-plan conversion feature included in the Small Business Jobs and Credit Act of 2010 and is not intended to be comprehensive. The Transamerica Center for Retirement Studies® ("The Center") is a non-profit corporation and private foundation. The Center may be funded by contributions from Transamerica Life Insurance Company and its affiliates or other unaffiliated third-parties. For more information about The Center, please refer to www.transamericacenter.org. The Center and its representatives cannot give ERISA, tax or legal advice. This material is provided for informational purposes only and should not be construed as ERISA, tax or legal advice. Interested parties must consult and rely solely upon their own independent advisors regarding their particular situation and the concepts presented here. Although care has been taken in preparing this material and presenting it accurately, The Center disclaims any express or implied warranty as to the accuracy of any material contained herein and any liability with respect to it.