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TCRS 2010-10: IRS Notice 2010-84, In-Plan Roth Conversion Guidance

In Notice 2010-84, the Internal Revenue Service provides guidance relating to in-plan conversions of non-Roth amounts from a 401(k) or 403(b) plan to a designated Roth account under the same plan. The in-plan Roth conversion provision was included in the Small Business Jobs Act of 2010, enacted on September 27, 2010.

Notice 2010-84 (click here for a copy), issued on November 26, 2010, is in question and answer format and provides guidance regarding the tax and distribution treatment as well as plan amendment and administrative requirements of in-plan Roth conversions. The Notice also provides clarification on such items as what amounts are eligible to be converted and recharacterization of converted amounts. Below is a brief summary of the highlights of Notice 2010-84.

Distribution Treatment

The Notice makes clear that while an in-plan Roth conversion is a distribution for certain purposes, it merely changes the account under a plan and the tax character of the amount converted, and is not treated as a distribution for purposes of the following:

- Plan loans – A plan loan included in an in-plan Roth conversion is not treated as a new loan, unless the repayment schedule is changed. The taxable amount of the conversion is the balance of the loan.
- Spousal consent – A married participant is not required to obtain spousal consent for the conversion.
- Special Notice of the Right to Defer Distribution – This notice is not triggered by an in-plan Roth conversion and the amount converted is taken into account in determining if the \$5,000 automatic cashout threshold is exceeded.
- Elimination of Optional Forms of Benefit – The distribution rights of a participant (such as the right to take an immediate distribution of a plan benefit) cannot be eliminated through an in-plan Roth conversion of that benefit. In addition, distribution restrictions for certain amounts, such as money purchase assets transferred to a 401(k) plan continue to be restricted after the conversion.

Tax Treatment

- Generally, the taxable amount of an in-plan Roth conversion is includible in income in the year of the conversion, except for a conversion in 2010. An individual electing to convert in 2010 may elect to include the entire taxable amount in 2010, otherwise, 50% of the amount is taxable in 2011 and the other 50% in 2012. An election to include the taxable amount in 2010 may not be changed after the individual's due date (including extensions) for filing his/her 2010 income tax return. This election is separate from any election made with respect to other qualified rollover distributions. To be eligible for the 2-year income spread, the conversion must occur by December 31, 2010, and the plan must have a designated Roth program in place at the time of conversion.
- The taxable amount of an in-plan Roth conversion is equal to the fair market value of the converted amount reduced by any basis the individual has in the converted amount. Note that this is the same amount that would be taxable if a rollover were made to a Roth IRA.
- Special income acceleration rules apply to individuals who elect to defer taxation to 2011 and 2012 and then take distributions during 2010 or 2011. For these individuals, the amount of their gross income in the year of distribution is increased by the taxable amount of the conversion that would otherwise be deferred to a later date.
- A special 5-year recapture rule applies. The 5-year period begins on January 1 of the taxable year of conversion and ends on the last day of the 5th taxable year in the period. This could present recordkeeping challenges for plan administrators and service providers because of the other 5-year rules that apply to designated Roth contributions.

- Notice 2010-84 confirms that the taxable amount of a direct in-plan Roth conversion is not subject to 20% withholding. However, an individual electing such a conversion may have to increase his/her withholding or make estimated tax payments to avoid an underpayment penalty.
- The 10% additional tax on early distributions under Internal Revenue Code section 72(t) does not apply to an in-plan Roth conversion, but will apply to a distribution of the taxable portion of an in-plan Roth conversion made within the 5-year recapture period.
- Q and As 7-13 of Notice 2010-84 contain detailed explanations and examples of how the taxable amount of an in-plan Roth conversion is determined and how the tax is calculated and attributed.

Clarification

- Any vested non-Roth amounts are eligible to be converted in an in-plan Roth conversion, but an amount is eligible to be converted only if the plan allows a rollover of such amount.
- Unlike a conversion or rollover to a Roth IRA, in-plan Roth converted amounts may not be recharacterized. In general, and subject to certain limitations, a traditional deductible IRA that has been converted to a Roth IRA may be recharacterized back to a deductible IRA.
- An in-plan Roth conversion may be accomplished by a direct conversion or by a distribution of funds and subsequent rollover to a designated Roth account within 60 days of the distribution.

Plan Amendment/Administrative Requirements

A plan amendment implementing an in-plan Roth conversion provision is not required to be adopted during 2010.

- For 401(k) plans, the deadline to adopt such an amendment is the later of the last day of the plan year in which the amendment is effective or December 31, 2011. This amendment must be effective as of the date the plan first operates in accordance with the amendment.
- For 403(b) plans, the deadline to adopt such an amendment is the later of the end of the remedial amendment period determined under IRS Announcement 2009-89 or the last day of the first plan year in which the amendment is effective, provided the amendment is effective as of the date the plan first operates under the amendment.
- The extended amendment deadline described above for 401(k) and 403(b) plans also apply to any plan amendment (i) permitting designated Roth contributions, (ii) permitting acceptance of rollovers by designated Roth accounts (iii) permitting in-plan Roth conversions and (iv) to a more restrictive provision of the plan described below. However, the extended deadline does not apply to an amendment adding a cash or deferred arrangement.
- A plan may be amended to allow non-Roth amounts (not previously permitted to be distributed under more restrictive terms of a plan) to be converted in an in-plan Roth conversion, while continuing the more restrictive distribution provisions. For example, a plan that does not permit in-service withdrawal of vested employer contributions may permit in-plan Roth conversions of those contributions while continuing to restrict the in-service distribution of such contributions.
- According to the Notice, a Roth program must be in place before an in-plan Roth conversion can be made. A Roth program is considered to be in place on a given date only if, with respect to compensation that could be deferred beginning on that date, eligible employees are provided the opportunity to make designated Roth contributions to a plan. Notice 2010-84 allows a plan to be amended retroactively to add a Roth program.
- The extended amendment deadline also applies to safe harbor 401(k) plans. The extension is to the later of December 31, 2011, or the day before the first day of the plan year in which the safe harbor provisions are effective. For example, if the plan has a July 1 – June 30 plan year, it may begin to operationally comply with the in-plan Roth conversion feature on July 1, 2010, without adopting the amendment until December 31, 2011.

Notices and Reporting

- Plan sponsors who adopt an in-plan Roth conversion feature must include information regarding the feature in the plan's 402(f) notice to participants who request a distribution. Q and A-5 of Notice 2010-84 includes language which may be used for this purpose.

- Guidance on the IRS' website at <http://www.irs.gov/retirement/article/0,,id=231775,00.html> states that an in-plan Roth conversion in 2010 must be reported on Form 1099-R. The amount converted must be reported in box 1, the taxable amount of the conversion in box 2a, the basis in box 5 and use distribution code "G" in box 7.
- Plans must report any distributions made in 2010 from designated Roth accounts allocable to in-plan Roth conversions on a separate Form 1099-R, with the amount of the distribution allocable to the in-plan Roth conversion entered in the blank box to the left of box 10.
- Participants who make an in-plan Roth conversion in 2010 must complete and file Form 8606 with their 2010 tax return. A separate Form 8606 must be completed and filed if such participant also rolled over amounts from a qualified retirement plan to a Roth IRA in 2010. A draft copy of the 2010 Form 8606 may be viewed on the Draft Tax Forms section of the IRS website.

This Summary is designed to provide an overview of IRS Notice 2010-84 providing guidance on in-plan Roth conversions 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.