

Employee Benefits Briefing

Roth Conversions Inside Savings Plans: Option Now Available

On September 27, 2010, President Obama signed into law the “Small Business Jobs Act of 2010.” Contained within the new law is a provision enabling 401(k) and 403(b) plans (collectively, “Savings Plans”) to permit participants to convert some or all of their existing pretax amounts into Roth accounts *within the existing Savings Plan*. This new statutory provision is purely optional and applies only if a Savings Plan permits participants to make Roth contributions to it. Also, the new statute does not expand any conversion opportunities that currently exist with respect to transfers to Roth IRAs. However, this new provision may make Roth conversions easier to accomplish for existing participants, and thus it may have some popularity.

Background

Savings Plans have been permitted to offer participants the opportunity to make Roth contributions since 2006. The primary difference between traditional pretax contributions and Roth contributions is that Roth contributions are not excluded from income when contributed to the Savings Plan, but they and earnings on such contributions are excluded from income when ultimately distributed (assuming certain holding requirements are satisfied). Savings Plans are not required to offer participants the opportunity to make Roth contributions, but if they make such contributions available, participants must be allowed to make either traditional pretax contributions or designated Roth contributions. Roth contributions are generally treated in the same manner as traditional pretax contributions

under Savings Plans for such purposes as nondiscrimination testing, contribution limits and distribution restrictions.

Prior to the enactment of the new law, if a participant desired to convert some or all of his or her Savings Plan account to a Roth account, the conversion could be accomplished only by the participant making a direct rollover distribution from the Savings Plan into a Roth IRA. Amounts converted to a Roth IRA (other than after-tax contributions) would be recognized as taxable income by the participant. If a distribution were rolled over directly to a Roth IRA, the 20 percent mandatory tax withholding would not apply, but in Notice 2008-30 (Q&A 6), the IRS provides that the participant and the plan sponsor could enter into a voluntary tax withholding agreement. For conversions that occur in 2010, the amount that must be recognized as income will be recognized in equal amounts in 2011 and 2012, unless the participant elects to recognize the whole amount in 2010.

New Statutory Provision

Under the new statutory provision, a Savings Plan that offers participants the opportunity to make Roth contributions may permit participants to elect a direct rollover of an otherwise eligible rollover distribution into a Roth account within the Savings Plan itself. The concept behind the statute is to permit Roth conversions to take place within the existing Savings Plan structures, without the need for the participant to establish a separate Roth IRA.

A Savings Plan may not establish Roth accounts solely to accept Roth conversions. A Savings Plan may permit the intraplan conversion only if it already offers participants the opportunity to make Roth contributions. In addition, amounts that may be rolled over into a Roth account must be amounts that might otherwise be distributed under the terms of the Savings Plan (there are no special advantageous distribution rules for Roth conversions). For example, if participants may take in-service withdrawals of vested amounts after attaining age 59½, those withdrawals are eligible rollover distributions and may be rolled over into a Roth account within the Savings Plan. By contrast, an active participant who has not attained age 59½ may not currently roll over pretax 401(k) or 403(b) contributions to a Roth account, because such contributions may not be distributed as part of an eligible rollover distribution until the participant attains age 59½, dies, becomes disabled or incurs a severance from employment.

The special tax rule described above relating to income recognition for 2010 Roth conversions also applies to rollovers to Roth accounts within a plan. Thus, the participant is allowed to include the amount that must be recognized as income in equal parts in 2011 and 2012.

The legislative history¹ to this new provision states that Savings Plans may be amended to expand the permissible distribution options available for direct rollover to a Roth account within the Savings Plan. For example, a Savings Plan may permit an active participant to take an in-service withdrawal of vested profit-sharing contributions that have been in the plan at least two years. If a Savings Plan does not currently permit such an in-service withdrawal, the Savings Plan may be amended to allow such a withdrawal, but condition eligibility for the withdrawal on the

participant's election to have the distribution directly rolled over to the designated Roth account under the Savings Plan.

Neither the statute nor the legislative history addresses whether tax withholding would be required on such a conversion. However, as noted above, under IRS Notice 2008-30 (Q&A 6) no mandatory withholding is required (but voluntary withholding is permitted) on a direct rollover to a Roth IRA. There is no reason to believe that similar rules will not apply to intraplan conversions once the IRS issues guidance under the new statute.

The tax rules applicable to Roth accounts in a qualified plan and Roth IRAs are not identical. For example, required minimum distributions at age 70½ apply to Roth contributions in a Savings Plan, but not in a Roth IRA. Any participant who is considering an intraplan Roth conversion should be advised to consult with a tax advisor before deciding whether to convert and whether to do so inside the Savings Plan or by using a Roth IRA.

Finally, the statute is effective for distributions made after the date of enactment. The legislative history anticipates that the IRS will establish a remedial amendment period to permit plans to offer intraplan conversions immediately, but have sufficient time to amend the Savings Plan to reflect this conversion feature.

If you have any questions regarding this bulletin, please contact **Philip L. Mowery** (312-609-7642) or **Paul F. Russell** (312-609-7740).

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¹ Technical Explanation of the Tax Provisions in Senate Amendment 4594 to H.R. 5297, the "Small Business Jobs Act of 2010," scheduled for consideration by the Senate on September 16, 2010 (pages 39–43).

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