LEGAL UPDATES

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Internal Plan Roth Conversions

Service

Employee Benefits & Executive Compensation

On September 27, 2010, President Obama signed the Small Business Jobs Act of 2010. Notwithstanding its name, the Act includes retirement plan provisions that are not limited to small businesses. First, governmental 457(b) plans will be able to have after-tax Roth accounts beginning in 2011. Second, an eligible participant in a 401(k), 403(b) or governmental 457(b) plan that allows designated Roth contributions may roll over an eligible distribution to the plan's designated Roth contribution accounts. This will allow plan participants to take advantage of Roth conversion options without rolling their plan account to an outside Roth IRA.

In order to offer an internal Roth rollover, an employer plan must have a qualified designated Roth program to which employees can make elective deferral contributions. Thus, a profit sharing plan that does not include a cash or deferred arrangement may not offer an internal Roth rollover. Also, a plan may not limit Roth accounts to only receiving internal rollovers.

A participant must be eligible for a distribution under the plan in order to make an internal Roth rollover, and the distribution restrictions that apply to elective deferral accounts under 401(k), 403(b), and 457(b) are not relaxed for internal Roth rollovers. For example, an internal Roth rollover from an elective deferral account would be allowed for an active participant only if the participant has reached age 59½ and would be eligible for an in-service distribution. If permitted by a plan, in-service distributions from profit sharing or discretionary matching contribution accounts may be made earlier than age 59½, although a plan generally may not permit such in-service distributions except to individuals who have been participants for at least five years or have reached normal retirement age, or with respect to amounts that have been in the plan for least two years. An employer may choose to condition eligibility for an in-service distribution option on the participant's rollover to the designated Roth contribution account.

A rollover to a designated Roth contribution account is a taxable distribution that is included in a participant's gross income in the year the Roth conversion occurs. However, a special rule applies to conversions that take place in 2010. Under the special rule, a participant may elect to defer until 2011 and 2012 — at 2011 and 2012 rates — the taxes on a conversion that takes place in 2010. If a participant elects to defer taxes on a 2010 conversion until 2011 and 2012 and the participant dies or receives a distribution of the amount converted before 2012, taxation will be accelerated to the tax year in which the death or distribution occurs. This special tax rule will not apply to governmental 457(b) plans because the rule applies only to Roth rollovers occurring in 2010, and governmental 457(b) plan will not be able to have Roth accounts until January 1, 2011.

The 10 percent early withdrawal tax on distributions made before a participant has attained age 59½ does not apply to distributions that are rolled over to designated Roth contribution accounts. Nevertheless, if a participant receives a distribution of the amount converted within the five-year holding period, the 10 percent early withdrawal tax will apply to the amount distributed.

Employers wishing to allow internal Roth rollovers should consider offering the option this year so that participants can take advantage of the special tax rule for 2010 conversions. The Act leaves many questions unanswered, such as the steps an employer must take, and when those steps must be taken, to offer 2010 conversions, and what must be done for a participant to accomplish a conversion in 2010. The IRS is expected to allow employers to offer internal Roth rollovers for 2010 distributions, and to follow up with the necessary plan amendments after 2010, but the IRS has not yet issued the needed guidance.

What This Means To You

A reason for a plan sponsor to offer internal Roth conversions is to keep assets in the plan, which may help to reduce per participant plan expenses. The Roth conversion feature may be implemented as early as 2010 in 401(k) and 403(b) plans, although it may be a challenge to develop employee communications and systems in time to offer internal Roth conversions in 2010. Governmental employers should consider adding Roth accounts, as well as allowing internal Roth rollovers, to 457(b) plans beginning in 2011.

Contact Info

If you have questions about this update, please contact your Husch Blackwell attorney.

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