Implementing the New 401(k) and 403(b) "In-Plan" Roth Conversion Option Requires Immediate Action

Legal Alert
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401(k) and 403(b) plans can now offer participants the option of converting their regular pre-tax account balances into Roth accounts within the plan. (Starting in 2011, governmental 457(b) plans will also be allowed to provide this feature). On Friday, November 26, 2010, the IRS released IRS Notice 2010-84 which provides guidance on how these "in-plan" conversions can be made. The IRS refers to these conversions as "in-plan Roth rollovers."

Although participants will be taxed on the amount they convert into a Roth account, their Roth account, including the investment earnings on that account, will come out totally tax-free when it is later paid out to them in a qualifying distribution. (This extremely favorable tax treatment makes a Roth account the vehicle of choice for investments, such as a small cap or emerging markets fund, that a participant believes will really "pop" at some point in the future since all of the gain is captured tax-free.)

Ordinarily, in-plan Roth rollovers are treated as taxable income in the year the conversion is made. However, a special rule applies for in-plan Roth rollovers made by December 31, 2010. For in-plan Roth rollovers that are made by the end of this year, one-half of the conversion amount will be taxed as income in 2011, and the other half taxed as income in 2012 at the tax rates in effect in those years, unless the participant elects to pay tax on the entire amount of the conversion as 2010 income at the 2010 tax rates. This election must be made by the due date (including extensions) for filing the participant's 2010 federal income tax return.

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Participants can make an in-plan Roth rollover only if they qualify for an "in-service distribution" under the terms of their 401(k) or 403(b) plan. If a plan contains the necessary authorizing language, participants can withdraw their vested funds after they turn age 59½. A plan may also provide that participants can withdraw their vested employer contributions if they have participated in the plan for at least five years or if the employer contributions have been in their account for at least two years.

The recently released IRS guidance has also cleared up some of the uncertainties about in-plan Roth rollovers, including pointing out that:

The mandatory 20 percent federal income tax withholding that normally applies to in-service distributions does not apply to in-plan Roth rollovers. However, the rollover amount will still be taxable income, so participants may need to adjust their regular withholding or make estimated tax payments to avoid an underpayment problem.

In-plan Roth rollovers are irrevocable. That is, after you elect to make such a rollover, you cannot "recharacterize" that Roth rollover account back to a regular pre-tax 401(k) account. This is opposite from the rule that applies to conversions of traditional IRAs to Roth IRAs. In the case of IRAs, you have until your tax filing extension deadline to change your mind and recharacterize your Roth IRA back into a traditional IRA. This avoids paying taxes on the amount you had converted into a Roth IRA.

In order to allow participants to take advantage of the two-year income tax spreading option that is only available for in-plan Roth rollovers made in 2010, a 401(k) or 403(b) plan must have the arrangements in place to allow for in-plan Roth rollovers by the end of this year. Doing this will require taking quite a bit of action in a short period of time, including:

Before you do anything else, check with your plan's recordkeeper to make sure its systems will be able to handle in plan Roth rollover elections that are to be effective this year (including setting up separate in-plan Roth rollover accounts). For example, we recently learned that one of the largest 401(k) plan service providers will be unable to modify its systems in time to allow for in-plan Roth rollovers in 2010.

Polling your participants to see if there is enough interest to make this year end "fire drill" worthwhile.

Developing the employee communications materials to alert participants to the new in-plan Roth rollover feature and the conversion election deadline.

Modifying administrative forms and procedures to allow participants to make their in plan Roth rollover elections.

The good news is that, under the recently released IRS guidance, plans do not have to be amended by the end of this year to add the in-plan Roth rollover feature. Generally, plans will have until December 31, 2011, to adopt the necessary amendment, provided that amendment is

adopted retroactive to the date the plan first put its in-plan Roth rollover program into effect. (403(b) plans may have a longer time period in which to make the necessary amendment. Generally, 403(b) plans have until the end of their remedial amendment period for bringing the plan into compliance with the 403(b) regulations to adopt the amendment adding the in-plan Roth rollover feature.) This delayed amendment deadline applies not only to the amendment adding the in-plan Roth rollover feature itself but also to any amendments needed to allow participants to make Roth contributions or take in-service distributions. Both of those features are a prerequisite for making in-plan Roth rollovers, so if a plan does not already have them, they will need to be added.

Questions?

For additional information, please contact Vince Cacciottoli in our Portland office.