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Retirement Plan Update

"In-Plan" Roth Conversions

A law change, effective January 1, 2010, permitted traditional IRAs to be converted to Roth IRAs without regard to the income limits that previously restricted such conversions. In addition, this change provided a valuable tax benefit for Roth conversions made in 2010: The amounts converted could be divided equally with half taxable in 2011 and the remainder taxable in 2012.

On September 27, 2010, with passage of the Small Business Jobs and Credit Act of 2010, these Roth conversion options were extended to 401(k) and 403(b) plans in 2010. Plan sponsors of 401(k) and 403(b) plans may permit participants to convert pre-tax plan accounts to after-tax Roth plan accounts. This is a welcome change, since it eliminates the previous law's requirement that participants had to withdraw their plan accounts and roll them over to take advantage of the IRA to Roth IRA conversion rules.

That's great news. The law, however, is very complex and has significant restrictions:

- The in-plan conversion feature requires the plan to offer a Roth account for salary deferrals.
- If the plan does not currently permit Roth accounts, it may be amended to do so before December 31, 2010.
- The amounts that are eligible for such conversions are limited to plan accounts that could otherwise be distributed currently, while the employee is still working…referred to as "in-service distributions".
- The plan must have such "in-service" distribution provisions with specific rules about eligibility (age and/or years of service) for these types of distributions.
- This means that, if pre-tax salary deferrals amounts are to be converted to after-tax Roth accounts, for example, the participant must be at least 59 ½, the statutory minimum age for "in-service" distributions of salary deferrals…plus, of course, the plan must permit distributions of salary deferrals at age 59 ½ to still-active employees.
- Terminated participants with balances remaining in the plan may convert their accounts, if the plan permits distributions of all vested accounts at employment termination.

The IRS has to provide more information to plan sponsors as to the actual mechanics of these conversions, tax reporting, participant election choices, and other administrative issues. Groups representing members of the retirement plan industry have requested answers to these and other specific questions, in order for us to assist our clients with Roth conversions that would withstand future scrutiny by the IRS and DOL.

We appreciate our clients' desire to assist participants by offering an in-plan Roth conversion feature and will continue to keep you updated as the IRS provides the additional guidance required for implementation of these new plan and tax benefits this year.

Should you have any questions regarding this Retirement Plan Update, contact our consulting team at 619-696-7284.

Retirement Plan Update is not intended as legal advice or as an opinion of specific facts.