



Legal Alert: IRS Issues Further Guidance Regarding In-Plan Roth Conversions, but Leaves Questions Unanswered

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Under the Small Business Jobs Act of 2010, since September 27 of this year, plans have been permitted in certain circumstances to allow participants (and beneficiaries who are surviving spouses) to convert their account balances (or portions of their account balances) to "Roth" accounts within the plan, much like conversion of a regular IRA to a Roth IRA. And, like an IRA conversion, the amount converted is taxable to the participant as if it had been rolled over to a Roth IRA, *i.e.*, as if it had been distributed, and converted after-tax amounts, which would not be taxable on distribution, are not taxable on conversion. But, in order to be able to elect a conversion, the participant must be otherwise eligible to receive a distribution that would qualify as an "eligible rollover distribution", which raises certain questions concerning the application of the rules governing "eligible rollover distributions."

First, an "eligible rollover distribution," unless distributed in a direct rollover, is subject to mandatory 20% income tax withholding. Though the in-plan conversion is not an actual distribution, it is taxed as if it were distributed, as opposed to being non-taxable like a direct rollover. On the other hand, rather than actually *being* an "eligible rollover distribution", the amount converted is an amount that otherwise *would have been* able to be distributed as an "eligible rollover distribution." So is it subject to 20% withholding? Or any withholding at all?

Second, since the amount converted is not thereby excluded from gross income (as would be the case if it were rolled over to a non-Roth account), is the taxable amount also subject to the 10% tax penalty if the participant has not reached age 59-1/2, and is not eligible for another exception?

Third, how is an in-plan conversion supposed to be reported, given the similarities to and differences from both regular distributions and rollovers? What about reporting a distribution of – or a distribution that includes – converted amounts?

The IRS has provided answers to these questions, but has done so on its website, under "Changes to Current Tax Forms, Instructions, and Publications," rather than issuing a formal Notice (see <http://www.irs.gov/formspubs/article/0,,id=109875,00.html>).

First, it confirms that there is no withholding *required* from an amount that is being converted (*i.e.*, no 20% withholding). But still unanswered is whether the participant who elects to convert and to incur taxable income may choose to have tax withheld from the converted (or convertible) amount; if so, since the amount withheld will not have been converted, would that amount itself constitute a *real* "eligible rollover distribution"? Of course, the participant will have additional tax obligations resulting from the conversion, and the IRS has noted elsewhere (see Notice 2010-84) that the participant "may have to increase his or her withholding or make estimated tax payments to avoid an underpayment penalty", but the participant may prefer to satisfy that obligation through withholding in connection with the conversion, if that is possible.

Next, it confirms that the 10% tax penalty does not apply in the case of an in-plan conversion. However, depending upon the answer to the above "voluntary withholding" question, there would also be a question concerning whether amounts withheld, which would be taxable, would also be subject to the penalty.

Third, the IRS advised that – at least for 2010 conversions – an in-plan conversion should be reported on Form 1099-R, using code G (normally used to indicate a non-Roth direct rollover). This should be fairly straightforward, but it does not address whether multiple codes can or should be used, if applicable, as they usually would be.

Finally, the IRS stated that any portion of a distribution from a designated Roth account that is allocable to an in-plan Roth conversion should be identified by indicating the amount in the blank box to the left of box 10 on the Form 1099-R on which the distribution is reported. However, where a distribution consists of both converted amounts and other Roth amounts, the distribution may be qualified in part and nonqualified in part (due to differing 5-year periods), making different distribution codes applicable to the different portions of the distribution, but such reporting presently cannot be done on a single Form 1099-R. There already are detailed ordering rules dictating how distributions are to be allocated among taxable and nontaxable portions of both in-plan Roth conversions and other Roth balances, and separate reporting would be required in order to reflect those allocations.

Hopefully, these and other questions will be answered in further guidance.

If you have any questions regarding new Roth conversions or any action you are required to take in order to provide such conversions in your plan, please contact the author of this Legal Alert, Jeffrey Ashendorf, at jashendorf@fordharrison.com, any other member of Ford & Harrison's Employee Benefits Practice Group, or the Ford & Harrison attorney with whom you usually work.