Converting To a Roth Account In An Employer-Sponsored Retirement Plan

10/28/2010

Mary Jo Larson

The option of converting to a Roth account within an employer-sponsored retirement plan -- as opposed to rolling assets over to a Roth IRA – is now available. The Small Business Jobs Act, signed into law on September 27, 2010, made this option immediately available, albeit in a more limited way than had been hoped.

Historically, the only way to convert assets held in a retirement plan to a Roth account was to take a distribution as soon as permitted by the plan, pay taxes on the distribution and roll the assets over to a Roth IRA. With the elimination in 2010 of the $100,000 compensation limit on those who could make Roth conversions, more participants have taken this route, often investing in higher cost IRAs and draining the assets in the employer-sponsored plan. Both plan sponsors and participants have wanted the option to make Roth conversions *within* the sponsor's retirement plan.

The new statute leaves many questions unanswered. Although the joint committee report that accompanied the legislation provides some additional insight, the report is not law. The IRS is working on issuing guidance to answer these questions quickly. The timing is critical because Roth conversions made in 2010 are entitled to special tax treatment, with income inclusion spread out over 2011 and 2012.

Plans Affected

Only those 401(k) and 403(b) plans that allow Roth elective deferrals can allow in-plan Roth conversions, although we expect that employers with plans that do not allow Roth deferrals will be able to take advantage of the Roth conversion option by adding Roth elective deferrals now. The new law also adds a Roth option for 457(b) plans effective in 2011, at which time in-plan Roth conversions will be available to those plans as well.

Eligible Amounts

Only amounts that are otherwise "eligible rollover distributions" under the plan may be converted to a Roth account. For example, a participant can convert previous 401(k) deferrals to a plan Roth account if the participant has reached age 59½, as long as the plan permits in-service distributions at age 59½. If the plan has other kinds of accounts with more liberal in-service distribution rules, conversions to a Roth account of those amounts could be made under those rules. For example, a plan that allows distributions of discretionary employer contributions that have been in the plan for at least two years could allow Roth conversions of those contributions. An employer may add new distribution timing options not currently offered, to the extent permitted by law, and may restrict those new options to Roth conversions, according to the joint committee report.

Taxation of Roth Conversions

All pre-tax contributions converted to a Roth account are subject to income tax, but not to the additional 10 percent early distribution penalty. For conversions made in 2010, the income can be deferred into 2011 and 2012. The conversions are treated like direct rollovers, so it is likely the IRS will not require withholding, and participants will have to pay the taxes with outside funds.

Plan Amendments

A plan amendment will be required to implement the Roth conversion option. Normally, any discretionary amendments must be adopted no later than the last day of the plan year. The joint committee report, however, suggested that the IRS allow an extended, retroactive amendment period to allow employers to adopt a Roth conversion provision. Although the IRS is likely to implement an extended time period for the addition of the Roth conversion option, the IRS is less likely to allow a retroactive amendment to include a Roth deferral provision if the plan does not currently have one or to expand the in-service distribution options available.

Employer Sponsor Action Steps

The IRS is encouraging plan sponsors to wait until guidance is issued before amending their plans to add a Roth conversion provision. While waiting, we suggest employer sponsors take the following steps:

- Decide whether you want to make a Roth conversion option available in your plan
- If so, consider whether it is desirable or even possible from an administrative perspective to implement the provision in 2010
- If you cannot implement in 2010, wait to implement until IRS guidance is issued
- If you want to and can implement a Roth conversion provision in 2010:
    - Notify the applicable administrative parties of what is coming
    - Either arrange for quick action by the employer's governing board following the IRS issuance of guidance or prepare a delegation resolution that approves the change in concept and delegates to an officer the ability to amend the plan and take any other steps needed to implement the change
    - Review the distribution timing options in the plan and decide whether additional options can or should be added and whether those new timing options should be limited to Roth conversions
    - If the plan does not currently provide for Roth elective deferrals, determine how long you can wait before adopting an amendment in 2010 for providing at least Roth deferrals and perhaps expanding distribution timing options

- Prepare employee communications explaining the new option

Please contact Mary Jo Larson (mlarson@wnj.com or 248.784.5183) or any member of the Warner Norcross & Judd Employee Benefits Group if you have any questions about converting to a Roth account.