The Rosenbaum Law Firm P.C.

Perspectives

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Roth 401(k) Conversions:Much Ado About Nothing.

Too many requirements will deprive most participants from making Roth 401(k) conversions.

On September 27th, President Obama signed the Small Business Jobs Act of 2010 into law. One provision of the law allows 401(k) plan participants to transfer their pre-tax contributions into a Roth provision of the Plan in 2010 and pay the taxes in 2011 and 2012. By transferring these contributions to a Roth provision of their 401(k) plan, plan participants would be allowed to have tax free distributions at retirement.

What may seem as a boon to 401(k) plan participants everywhere, the provision is so limiting that very few 401(k) participants will actually be allowed to exercise and for those who can exercise it, very few will because of the gambling proposition of any Roth conversion. What is a benefit for a 401(k) participant is really a boon for the government as the provision to received added tax revenue now, rather than waiting for participants to retire and pay taxes later.

As for the limitations, a participant will only be allowed to convert contributions that would be allowed under a 401(k) plan by law and by the participant's plan. Therefore, participants will only be allowed to convert their salary deferrals and matching contributions until they attain age 59 ½ (a hardship distribution is not considered an allowed distribution for a Roth conversion). A participant will only be allowed to convert profit sharing contributions based on the plan's in-service distribution option for that contribution and by law; it must require some time requirement (a minimum of 2 years). Also, the conversion will only be allowed if the participant's 401(k) plan has a Roth provision and curiously the law states that an employer can not adopt a Roth provision solely to allow the conversion (how will the government prove that?).

Even if a participant can jump through those hoops, some factors weigh against making the conversion. First off, a conversion will require the payment of income taxes in 2011 and 2012 on contributions that were always tax deferred. Also a Roth conversion only makes sense for participants who are willing to bet the Roth conversion gamble. The Roth conversion gamble is that paying taxes now and doing the conversion makes sense because these participants believe income tax rates will rise, the stock will rise over time, and the government will abide by not taxing Roth distributions as promised. How many 401(k) participants are willing to make that bet when they are 59 ½ and intend to retire after 65? Seeing how the stock market has performed over the last 10 years, not many.

Also, keep in mind that Roth 401(k) will still require minimum distributions (even though they are tax free). However that can be avoided, if the participant makes an in-service distribution (if allowed by the Plan) and has that distribution rolled over to a Roth IRA (which requires no minimum distributions).

Guidance suggests that any Plan interested in this Roth conversion, an amendment will have to be put in place. Despite all these hurdles, if you are interested in the conversion, please contact me.

Most Popular Articles on JDSupra.

The Rosenbaum Law Firm P.C. has the #2 and #13 Most Popular Articles on JDSupra.

JDSupra.com which is a website that houses articles from law firms around the country has announced the most widely read articles on their website for the month of September 2010. Two articles written by this Firm was on the list of the Top 25 Most Read Articles on their site. “The Top 10 Major Misconceptions Plan Sponsors Have About Retirement Plans” was #2 on their list and “The Myth Of Free 401(k) Administration” was listed #13. All of our articles can be found at http://www.jdsupra.com/profile/Ary_Rosenbaum_docs/.

Mutual fund company TPAs and the myth of free 401(k) administration.

In England, many of the top pubs are owned by British breweries because watering holes are an effective means of beer distribution. Pepsico (owners of Pepsi) used to own Yum brands (KFC, Taco Bell, Pizza Hut, etc.) for that very same reason.

The 401(k) industry is dominated by mutual funds, so it should come as no shock that many mutual funds companies offer services as a third party administrator (TPA) because it's an effective means of distributing their mutual funds. Mutual funds distribution is extremely important for mutual funds companies because their bread and butter are the funds' asset management fees and more assets under management equal more revenue for the mutual fund company.

While many mutual funds companies only offer TPA services for larger plans, they are a few mutual funds companies that have been rather aggressive in offering TPA services to small and medium size plans. While mutual fund companies do offer an attractive alternative as part of a one stop shop, plan sponsors are under misimpression that the mutual fund companies' TPA services are free.

As stated in a previous article about 401(k) administration, there is no such thing as a free lunch or free 401(k) administration. Mutual fund companies make their money as a TPA through those very same mutual fund management fees that I had discussed earlier. Many of the same companies that offer TPA services are the very same mutual funds companies that offer revenue sharing or sub TA fees to TPAs for plans that use their funds. So by keeping plans under their roof, these mutual funds companies can keep their revenue sharing/ sub-TA fees to themselves. These mutual fund companies also guarantee the fees they make, by requiring that a percentage of a plan's assets (up to 100%) be invested into their own proprietary mutual funds. I recently came across a 401(k) plan with T. Rowe Price as a TPA that offered 12 mutual funds to participants for directed investment and all 12 funds were T. Rowe Price. T. Rowe Price is an excellent fund company, but I find it hard to believe that out of 8,000+ mutual funds, only T. Rowe Price funds MADE THE GRADE.

For plan sponsors and trustees who serve as fiduciaries under ERISA, it is a question of the prudence rule and whether it is prudent to offer investments into a specific mutual fund company, only because that mutual fund company is the TPA. While some mutual fund companies have sterling reputations, there are a still a number of mutual fund companies who have been tainted by the late trading scandals of the last decade, as well as poor performance and high fees. All plan sponsors that utilize a mutual fund company as a TPA should understand that there is a cost involved with their plan's administration, as well as being advised as to the standing of the mutual fund company within the entire mutual fund industry to make sure it doesn't become the next Steadman fund family.

Plan sponsors should consult with their 401(k) financial advisor to determine whether a mutual fund company as a TPA is the right fit for them. Mutual fund companies may be an attractive option for some, but plan that offer what is known as out of the box provisions may not be a good fit, as well as a plan sponsor that wants unbundled options in the selection of mutual funds.

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