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Employers Permitted to Allow Conversion of Retirement Plan Accounts to In-Plan Roth Accounts

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Employers that sponsor defined contribution retirement plans, such as 401(k), 403(b) plans and governmental 457(b) plans, can now allow certain participants to convert their retirement plan accounts into "Roth" accounts within the plan, through an "in-plan Roth conversion." In-plan Roth conversions are permitted under the Small Business Jobs Act of 2010, which was signed by President Obama on September 27. The chief tax advantage of a Roth account is that, when distributions are made from it, they are entirely tax-free, in the same manner as a Roth IRA.

An in-plan Roth conversion is an in-plan rollover of any or all of a plan participant's account (other than amounts made as Roth contributions to the plan) to a designated Roth account in the plan. The plan must permit Roth contributions and be amended to permit the in-plan Roth conversions. In addition, the participant must be at least age 59½ to make the in-plan Roth conversion. If the plan does not now permit in-service distributions at age 59½, it must be amended to do so, and the amendment can limit such distributions to amounts used in an in-plan Roth conversion.

Prior to this legislation, a participant who was eligible for an in-service distribution could achieve the same result by making a direct transfer to a Roth IRA, but this feature allows the money to stay in the plan, where it can remain invested in the plan's investment options.

A participant who elects an in-plan Roth conversion has taxable income to the same extent as if he or she simply took a distribution from the plan. Participants who elect a Roth conversion during 2010 recognize the income evenly in 2011 and 2012, unless an election is made to recognize it in 2010. After 2010, the participant recognizes taxable income for the year of the in-plan Roth conversion. There is no income limitation above which one cannot make an in-plan Roth conversion, either in 2010 or in subsequent years.

Employers who would like to offer the in-plan Roth conversion feature should begin the process as soon as possible, so that participants who wish to can take advantage of the spreading of income from the conversion over two years. The explanation of these provisions issued by the Joint Committee on Taxation states that it is intended that employers can offer the in-house Roth conversion in 2010, and that the IRS will provide a "remedial amendment period" sufficient for later amendment of plans to reflect these changes.

The Small Business Jobs Act of 2010 can be found here.
The Joint Committee on Taxation explanation of the Small Business Jobs Act of 2010 can be found here.

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