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In-Plan Roth Conversions

Under the Small Business Jobs and Credit Act of 2010 (the "Act"), signed into law on September 27, 2010, a 401(k) plan that allows Roth 401(k) contributions can be amended to permit "in-plan" Roth conversions.

Prior to the Act, an individual could rollover a retirement plan distribution into a Roth IRA.¹ Effective January 1, 2010, the limitation that precluded individuals whose adjusted gross income exceeded \$100,000 from taking advantage of the rollover option expired. Employer groups expressed concern that as a result of the income threshold being lifted, many high-income employees would take advantage of Roth IRA conversions and thereby drain a large amount of assets from 401(k) plans.² As part of a revenue-raising measure and to avoid this "leakage" problem, the Act amends the Internal Revenue Code by allowing participants to convert pre-tax 401(k) assets into Roth assets within a qualified plan.

In accordance with the Act, an employer may amend its 401(k) plan to allow participants who are otherwise eligible to take a distribution (for example, upon attainment of age 59½) to elect to roll their "eligible rollover distribution" to a Roth account within the plan.³ The amendment could also permit participants to convert after-tax or rollover money at any time, and/or allow participants under age 59½ to convert certain employer contributions. The rollover opportunity could be limited so as to prevent participants from taking distributions before termination of employment.⁴

For distributions that are converted in 2010, the participant can choose to include the entire previously untaxed portion of the distribution in income in 2010, or instead include half of the taxable amount in 2011 and half in 2012.⁵ Any such distribution will not be subject to the 10% early withdrawal penalty.⁶ The ability to defer half the tax is limited to 2010 distributions, thereby providing an incentive to offer in-plan Roth conversions before year-end.

A plan must have a Roth contribution feature in order to allow in-plan Roth conversions.⁷ If a plan does not have a Roth feature, it may be amended to offer a Roth component and allow in-plan conversions, but a Roth account cannot be established solely for the purpose of accepting rollover contributions.⁸ Participants must be notified if a plan is amended to allow in-plan conversions to designated Roth accounts.⁹ Although the Act does not address the timing of plan amendments, initial guidance indicates that the IRS will provide employers with a remedial amendment period which allows employers to offer in-plan conversions for distributions during 2010 while deferring adoption of the amendment reflecting the conversion option.¹⁰ There are still a number of unresolved issues, including how to handle tax withholding and reporting.¹¹ Further, the ability to take advantage of this opportunity will require that the plan's recordkeeper can implement the option within a short time frame and that the plan administrator can quickly communicate it to the participants.

If you have any questions about in-plan Roth conversions or any other employee benefits or executive compensation matter, please contact a member of Day Pitney's Employee Benefits group.