

IRS Guidance on In-Plan Roth Conversion Option Now Available

As we previously informed you, the Small Business Jobs and Credit Act of 2010 created a new way to save using Roth accounts in a 401(k) or 403(b) Plan. Under the new law, a participant can convert non-Roth money into Roth money without taking a distribution from the plan, the conversion can happen inside the plan. Previously, if a 401(k) or 403(b) plan participant wanted to convert non-Roth money into Roth money, he or she would take a distribution from the 401(k) or 403(b) plan and roll it to a Roth IRA.

Any money other than existing Roth money can be converted to Roth money. The converted amount will be held in a specially designated account and accumulate earnings tax-free. If the distribution timing rules are followed, all distributions from the account are nontaxable.

In order to use the new conversion option, a participant must be entitled to receive a distribution from the plan (other than a hardship distribution, a required minimum distribution, annuity payments or installment payments for more than 10 years). Spousal consent, even if otherwise applicable to your plan, is not applicable to the in-plan Roth conversion.

The participant will have a taxable event upon the conversion. If the conversion takes place in 2010, the converted amount will be included in income one-half in the 2011 tax year and one-half in the 2012 tax year (or all in the 2010 tax year, if the participant prefers). For post-2010 conversions, the converted amount is includible in income in the year of conversion. The conversion is not subject to the 10% early withdrawal penalty, although the penalty may apply to distributions made from the conversion account within 5 years of conversion. Surviving spouses and alternate payees under a QDRO can do a Roth conversion inside a plan, but non-spouse beneficiaries cannot.

In order for a participant to do a Roth conversion inside a plan, the plan must be amended to allow such conversions. The IRS has issued guidance allowing such amendments to be made by the later of the last day of the plan year in which the amendment is effective or December 31, 2011. This means plans do not have to be amended this year to allow for 2010 conversions. However, in order to document a plan sponsor's intent to allow in-plan Roth conversions, we recommend adopting an administrative policy or adopting resolution allowing for the conversions. You also will need to notify participants of the availability of the in-plan Roth conversion option. We can prepare these documents for you if you want to allow in-plan Roth conversions. Once an amendment is available from our document provider, we also will provide that to you.

If a plan doesn't currently allow Roth contributions, they can be added at this time. However, a plan cannot offer only Roth deferrals; it also must offer pre-tax deferrals. Also, a plan cannot add a Roth feature solely to allow Roth conversions; it must allow Roth deferral contributions to be made as well. A plan that doesn't currently provide for in-service distributions could be amended to add them, and could limit such in-service distributions to distributions solely for Roth conversion purposes.

Any in-service distribution options currently applicable to the non-Roth money being converted to Roth money must be preserved. For example, if your plan allows in-service distributions of non-Roth money at age 59½, the converted money must be available for in-service distributions at age 59½. However, ongoing Roth contributions, which generally have not been available for in-service distributions under our plans, could remain unavailable for in-service distributions.

If you would like more information regarding Roth deferrals and the in-plan conversion option, please contact your Employee Benefit Resources consultant.



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