

In-Plan Roth Conversions Now Available

Background

On September 27, 2010, President Obama signed the Small Business Jobs Act of 2010. The new law includes a provision permitting 401(k) and 403(b) plans to offer conversion of eligible account balances to a Roth account within the plan, instead of requiring rollover to a Roth IRA. However, account balances that are **not** eligible for withdrawal **cannot** be converted to Roth.

The in-plan Roth conversion provision became effective immediately upon enactment of the new law.

What Assets Can Be Converted to Roth?

Plans with a Roth feature can now permit participants who have attained age 59½ to convert employee pre-tax deferrals to a Roth account. Vested employer contributions that are not subject to 401(k) withdrawal restrictions can also be converted to a Roth account, regardless of the participant's age, if the contributions have been in the plan for at least two years, or the employee has been a participant in the plan for at least five years. Please note that safe harbor contributions are subject to 401(k) withdrawal restrictions and cannot be converted prior to age 59½.

Special Tax Treatment

In-plan Roth conversions completed in 2010 are eligible for the same special tax treatment rules that apply to 2010 Roth IRA conversions. Participants can choose to recognize the converted amounts ratably over two years (2011 and 2012), or can include the entire amount in taxable income for 2010. However, unlike IRA conversions, the ability to reverse the transaction if the timing of the conversion turns out to be bad (for example, if the market drops after the conversion) is **not** available for in-plan Roth conversions.

In addition, the 10% early distribution penalty tax for withdrawals prior to age 59½ will not be assessed on Roth conversions.

Other Issues to Consider

- The plan must have a Roth account that is accepting, or has accepted, Roth elective deferrals. A plan cannot establish Roth accounts solely for the purpose of accepting these in-plan conversions.
- Pre-death required minimum distribution rules will still apply to Roth conversions within the plan. Roth IRAs are not subject to these rules.
- Plans can permit conversions to Roth accounts without having to permit actual distributions from the plan. A plan that does not currently permit in-service withdrawals will have to add this feature to facilitate these conversions. However, this new feature can be limited to Roth conversions within the plan.
- A plan amendment will be required to add this feature. However, the Congressional committee's technical report says that employers can begin offering in-plan Roth conversions for 2010 before changing the plan, adopting a "remedial amendment" later.
- In order to add this feature, your 401(k) or 403(b) recordkeeper will need to update its systems to handle in-plan conversions.
- A participant communication strategy will also need to be developed.

What Should Plan Sponsors Do Now?

If you are not familiar with Roth conversion rules, you can learn more by visiting our website and downloading *Roth Conversions: A Closer Look* (www.kravitzinc.com/pubsarticles/pubs_401k.html).

If you would like to add this new feature to your plan, or if you have questions about Roth conversion options, please contact your Kravitz Consultant to discuss next steps.

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