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New Law Allows Conversion to Roth Within a 401(k) Plan

On September 27, 2010, the President signed into law the Small Business Jobs Act of 2010 (SBJA). SBJA includes a provision which allows participants in a 401(k) plan to convert assets from a pre-tax status to a Roth account within the plan. Under previous law, a 401(k) plan participant who wished to convert to a Roth account was required to move assets from the 401(k) plan to a Roth IRA. Under the new law a participant can accomplish the conversion through a transfer of assets within a 401(k) plan without having to remove assets from the plan.

To be eligible for an in-plan Roth conversion, the following conditions must be satisfied:

Participant must be eligible for a distribution under the plan. SBJA indicates that only amounts that are currently eligible for a distribution may be converted to a Roth account. A participant may qualify for a distribution either as an in-service withdrawal or a distribution due to a severance from employment. IRS rules prohibit in-service withdrawal of pre-tax deferrals and safe harbor contributions prior to attainment of age 59 ½. A with-

drawal of employer contributions may be less restrictive and be made available upon attainment of a certain specified age or after an individual has been a participant in the plan for a minimum of five years. The participant must be 100 percent vested in order to be eligible for

“...a participant can accomplish the conversion through a transfer of assets within a 401(k) plan...”

an in-service withdrawal.

SBJA indicates that a plan sponsor may add a withdrawal provision to a plan

that is only available to those who are completing an in-plan conversion (e.g., employer sources are made available for in-service withdrawal upon attainment of age 50, but only for a participant who elects an in-plan conversion to Roth). The in-plan conversion is only available for distributions that would otherwise be eligible for rollover. Therefore, hardship withdrawals, required minimum distributions, installment payments that are set up to last for more than ten years and corrective distributions are not eligible for an in-plan Roth conversion.

The plan must allow for Roth 401(k) contributions. The in-plan Roth conversion is only available if the plan

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allows for ongoing Roth 401(k) contributions. A plan that does not currently allow Roth contributions can be amended to add a Roth feature. However, the ability to make Roth contributions must be made available to all eligible participants, not just those who wish to make an in-plan Roth conversion.

The provisions of the plan must allow for a conversion to a Roth account. The plan document will need to be updated to allow for this type of conversion. It is expected that the IRS will provide guidance on what will need to be included in the plan document, as well as a timeframe for adopting the amendment.

Tax Issues

An in-plan conversion is similar to a conversion to a Roth IRA in that if it is complete in 2010 it will be taxed to the participant ratably in 2011 and 2012 unless the participant elects to be taxed in 2010. In addition, the conversion is not subject to the 10 percent early withdrawal tax. However, while a conversion to a Roth IRA can be undone up to the individual's tax filing deadline, the in-plan conversion cannot be undone once it is complete. In addition, amounts converted to a Roth IRA are not subject to the Required Minimum Distribution rules, while amounts done as an in-plan conversion will be subject to those rules.

SBJA did not address whether there should/can be any income tax withholding at the time of conversion or whether the participant is to pay the taxes at the time personal taxes are filed. On October 5th, the IRS issued guidance indicating that an individual who elects to include the conversion as taxable income in 2010 cannot revoke that election after his/her due date, including extensions, for filing 2010 taxes. The IRS also noted that a participant may owe estimated taxes on the taxable amount of the conversion for the year or years in which it is included in taxable income and may incur an underpayment penalty. Therefore, a participant should discuss the impacts of an in-plan Roth conversion with their tax advisor.

Action and Next Steps

This provision of the law is effective immediately. If you are interested in adding the in-plan Roth conversion option to your plan, please contact your account representative for details.

If you have any questions, please contact your Relationship Manager at 800.548.2995.