

Compliance Bulletin: In-Plan Roth Conversions

November 2010

On September 23, 2010, Congress passed the Small Business Jobs Act. Effective immediately, the Act allows 401(k), 403(b) and governmental 457(b) plans the ability to allow participants eligible for a distribution to roll their pre-tax account balances into a designated Roth account within the plan. Such transactions that occur in 2010 will allow participants the flexibility to pay their resulting tax entirely in 2010, or split the tax 50/50 over 2011 and 2012. This has created a sense of urgency among some plans and participants who want to be able to take advantage of the two-year special tax treatment for 2010 conversions.

Further details of this provision of the bill include:

- A plan cannot establish a designated Roth account solely for purposes of receiving these rollovers. The act requires that a designated Roth source must be available for participants' elective deferrals as well.
- The in-plan conversion feature is an optional feature. A plan may, but is not required to, add this provision. The provision may be added in 2010 or later years.

However, as detailed below, plan sponsors should proceed with caution. Many of the issues raised in the new law require further guidance from Treasury Department.

The following issues appear to require guidance before they can be properly addressed by plan sponsors and record keepers.

Plan Amendments

Plans that currently offer the Roth feature must amend their plans if they wish to add the in-plan conversion feature. Amendments for these plans may be made in the remedial amendment period or generally by the due date for the plan's Form 5500 for the year in which the change is adopted.

Plans that currently do not offer a Roth feature must first be amended to allow for the Roth feature before the in-plan conversion feature can be added. It is currently unclear whether these can be amended to add the Roth feature and the in-plan conversion feature in the remedial amendment period, or if such an amendment must be adopted before the end of the plan year. If the latter is true, the time frame in which to execute the amendment is very limited.

Record Keeping/Administration

The Act does not provide details on how, and if, in-plan conversion amounts must be segregated from regular Roth deferrals for record keeping purposes. If guidance requires that Roth conversion assets be segregated, record keepers will need to modify their systems to accommodate the new requirement.

Conversion Eligibility

Although some confusion has been reported regarding what amounts are eligible for in-plan conversions, the legislation is clear that conversions are only available for amounts otherwise eligible for a distribution under the plan. However, it is not clear whether the law allows a plan to add an in-service distribution feature that can only be used for the purpose of making an in-plan conversion.

Tax Withholding

An in-plan Roth conversion technically involves a distribution and a subsequent rollover contribution. Although a waiver exists for a rollover and conversion to a Roth IRA, the Treasury has not yet issued a comparable waiver for in-plan conversions. Absent a waiver, this creates compliance and financial risks for the plan and plan sponsor.

Additionally, plan sponsors may want to consider the following as they discuss the possibility of allowing Roth in-plan conversions:

Re-characterization

An in-plan Roth conversion is irrevocable and cannot be re-characterized or restored back to its pre-tax after the conversion is complete. In contrast, a Roth IRA can be re-characterized before the participant's tax filing deadline. The ability to re-characterize can be helpful to participants who convert and later realize that they are unable to pay the tax liability on the conversion. Plan sponsors should consider whether they will be able to fully inform participants about these implications between now and December 31, 2010.

Conclusion

Plan sponsors should consider the issues carefully, be mindful of the impact to the plan as a whole, and consider that the Roth feature and Roth conversions may make sense for some investors and not so for others. Plan sponsors should consult with their counsel if they remain interested in permitting 2010 conversions. Once further guidance is received, plan sponsors will more easily be able to move forward in implementing in-plan Roth conversions with confidence that they are doing so properly.

This bulletin is for informational purposes only and should not be construed as legal advice. Consult your own counsel regarding your specific issues and situation.

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