Hinkle Client Alert

HINKLE LAW FIRM LLC

NEW LAW ALLOWING FOR IN-PLAN ROTH CONVERSIONS MAY PRESENT TAX-SAVING OPPORTUNITY FOR MANY PARTICIPANTS

APRIL 18, 2011

Do you have employees who would like to convert their retirement money to a Roth account but are unable to do so because all of their money is locked into your company's 401(k), 403(b), or 457(b) plan? Are you interested in helping your employees find a way to potentially avoid the payment of substantial amounts of taxes after they retire? If so, then Congress just may have a deal for you!

Last Fall, the President signed into law a major piece of legislation providing participants in 401(k), 403(b), and 457(b) plans the opportunity – if their employer's plan so allows – to convert part or all of their vested non-Roth accounts into Roth accounts without having to take a distribution from the plan, a conversion that potentially could save some participants a significant amount in taxes over many years.

Prior to the passage of this new law, a participant who wanted to convert his/her account in a qualified plan to a Roth account (thus accelerating taxation and allowing future earnings to accrue tax free) would have first had to take a distribution from the plan and then roll that distribution over to a Roth IRA or some other qualified plan with a Roth feature. For most employees this would require them to terminate employment, which is probably not something that would be desirable in most cases. The new "in-plan" Roth conversion rules, however, offer participants most of the advantages of a Roth rollover without requiring the participant's funds to leave the plan.

The new in-plan Roth conversion feature is optional and employers are under no obligation to adopt it as part of their 401(k), 403(b), or 457(b) plans. But employers who wish to provide their employees with greater flexibility in retirement planning may want to consider amending their plans to provide this tax-saving opportunity.

Only those plans that contain provisions allowing employees to make Roth deferrals are eligible to establish an in-plan Roth conversion feature. If an employer does not already have a Roth feature in the plan that it sponsors, however, it may amend the plan to add one. An employer adding an in-plan Roth conversion component to its plan also will need to revise its plan document to address the terms and conditions that will apply to the Roth conversion. As is normal in this area, there are complex rules that will have to be considered.

For More Information. The requirements related to in-plan Roth conversions are explained in more detail in the accompanying Memorandum we have prepared.

If you have questions regarding the new in-plan Roth conversion provisions or any other aspect of your qualified plan, please feel free to call Eric Namee, Steven Smith, or Brad Schlozman at (316) 267-2000.

MEMORANDUM

NEW LAW ALLOWING FOR IN-PLAN ROTH CONVERSIONS MAY PRESENT TAX-SAVING OPPORTUNITY FOR MANY PARTICIPANTS

APRIL 18, 2011

Last September, the President signed into law the Small Business Jobs Act of 2010, a major piece of legislation designed in part to encourage the conversion of pre-tax accounts to Roth accounts in certain qualified retirement plans. The new law allows employers sponsoring 401(k), 403(b), or 457(b) plans to amend those plans in order to allow participants to convert part or all of their vested non-Roth accounts into Roth accounts without having to take a distribution from the plan, a move that potentially could save participants a substantial amount in taxes over many years.

Before the passage of this new law, a participant who wanted to convert his/her account in a qualified plan to a Roth account (thus accelerating taxation and allowing future earnings to accrue tax free) would have first had to take a distribution from the plan and then roll the distribution over to a Roth IRA or to some other qualified plan with a Roth feature. The new "in-plan" Roth conversion rules, however, offer participants most of the advantages of a Roth rollover without requiring the participant's funds to leave the plan.

Although the new in-plan Roth conversion feature is optional and employers are under no obligation to adopt it as part of their plans, it is a feature that many employers may want to consider as a means of providing participants greater flexibility in retirement planning.

I. – ROTH DEFERRALS IN QUALIFIED RETIREMENT PLANS

Before explaining the new in-plan Roth rollover rules, a little background on the Roth feature in qualified plans will be helpful. Qualified plans have been permitted to include Roth deferral provisions since 2006. If an employer sponsoring a 401(k), 403(b), or 457(b) plan has elected to include a Roth feature in the plan, the elective deferrals that participants make to their accounts under the plan are immediately taxed (as opposed to having the taxes deferred until the time of distribution, as is true of traditional non-Roth deferrals and other employer contributions). In return for this immediate taxation, <u>none of the earnings on the Roth deferrals are subject to taxation,</u> provided certain conditions are satisfied at the time the participant's account is distributed. (If all of the conditions are met, the Internal Revenue Code (the "Code") refers to the distribution as a "qualified distribution".)

In order for the distribution of a Roth deferral (sometimes referred to as a "designated Roth contribution") to be a "qualified distribution" under the Code, the distribution must be made <u>after</u>:

(A) The participant has attained age 59½, died, or become disabled; <u>and</u>

(B) The participant has at least five years of participation in the Roth feature. (The five-year period of Roth participation generally begins on January 1 of the year in which the participant first made a Roth contribution under the plan. If the participant directly rolled over into the plan amounts that had

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been deferred as part of a Roth feature in a separate 401(k), 403(b), or 457(b) plan, then the five-year period may include the Roth participation under the prior plan.)

If a distribution from a Roth account does not meet these requirements (and is thus not a "qualified distribution"), the portion of the distribution that is attributable to the *earnings* on the participant's designated Roth contributions will be included in his/her gross income for income tax purposes.

Moreover, if the distribution occurs prior to the expiration of the five-year period of Roth participation, then the participant's taxable earnings may also be subject to a 10% penalty on early distribution (unless an exception applies, such as the participant having already attained age 59½ or having separated from service after attaining age 55).

Apart from these special taxation rules, Roth deferrals are generally subject to the same rules as traditional 401(k) pre-tax deferrals. For example, designated Roth contributions must be 100% vested when made, are subject to the average deferral percentage non-discrimination test, and may only be distributed following a participant's attainment of age 59½, death, disability, hardship, severance from employment, or termination of the plan.

II. – In-Plan Roth Conversions

In late November of last year, the IRS issued Notice 2010-84, which fleshed out many of the rules governing the new optional in-plan Roth conversion feature. Among the most important clarifications were those pertaining to which plans are eligible to adopt this feature and what amounts in each participant's account are eligible for conversion.

A. – Plans Eligible to Adopt an In-Plan Roth Conversion Feature

The new in-plan Roth conversion rights apply only to those 401(k), 403(b), and governmental 457(b) plans that have a designated Roth deferral feature "in place" at the time of the conversion. A Roth program is in place on a given date only if eligible employees have the ability to make Roth deferrals to the plan on that date. If an employer does not already have a Roth feature in the plan that it sponsors, it may amend the plan to add one. The deadline for adopting such an amendment is summarized in Part F below.

B. – Amounts Eligible to Be Converted as Part of an In-Plan Roth Conversion

Employers adopting in-plan Roth conversion features to their plans have considerable flexibility in determining what amounts in each participant's account are eligible for conversion. The Internal Revenue Code (the "Code") and IRS rules allow for the conversion of any *vested* amount held in any plan account – other than a designated Roth account – that is *eligible for a distribution*. Stated differently, only "eligible rollover distributions" are eligible for an in-plan Roth conversion. This includes pre-tax elective deferrals, profit sharing contributions, safe harbor contributions, non-Roth rollover contributions, other non-elective contributions, after-tax employee contributions, and Qualified Non-Elective Contributions. A sponsoring employer can limit, however, the particular accounts from which in-plan Roth conversions will be accepted, as long as such limits are imposed in a non-discriminatory manner (i.e., do not overly benefit highly compensated employees).

An in-plan Roth conversion is, at its heart, a distribution. Accordingly, as noted above, a conversion is permitted only if there has been a distributable event. In other words, in-plan Roth conversions can only be made in connection with amounts that are eligible to be rolled over pursuant to *both the Code and the terms of the plan document*. The Code's distribution restrictions on the various types of accounts are set forth below:

- *Pre-Tax Elective Deferrals*. The Code does not authorize pre-tax elective deferrals to be distributed until a participant has attained age 59½, died, become disabled, terminated employment, or become eligible for a qualified reservist distribution due to his/her military service.

- *Employer Contributions*. The Code permits distribution of employer contributions (e.g., matching contributions, profit sharing contributions, non-elective contributions, etc.) if (a) such amounts are vested and have been in the plan for at least two years or (b) the participant has participated in the plan for at least five years. (*Word of caution*: the IRS treats employer "safe harbor" contributions like pre-tax elective deferrals for purposes of distribution restrictions.)[1]

- *After-Tax Employee Contributions*. The Code authorizes after-tax employee contributions to be distributed at any time.

- *Rollover Contributions*. The Code authorizes rollover contributions to be distributed at any time.

Most plan sponsors impose much more restrictive rules on distributions in the plan document than those set forth in the Code. Employers wishing to adopt an in-plan Roth conversion feature for their plans likely will want to liberalize some of their plan's distribution rules in order to take maximum advantage of the new legislation.

Because in-plan Roth conversions are available only for eligible rollover distributions, amounts that cannot be treated as eligible rollover distributions – e.g., hardship distributions, required minimum distributions ("RMD"), lifetime annuity payments, installment payments of ten years or more, deemed distributions (from plan loans), certain corrective contributions, etc. – may not be considered in the Roth conversion.

C. – The Non-Distribution Distribution – IRS Sleight of Hand

Some employers may worry that loosening the distribution rules under the plan could have counterproductive effects by encouraging employees to remove money from the plan that should be saved for retirement. The recent IRS Notice addresses this concern by expressly allowing plans to offer an in-plan Roth conversion feature without actually allowing participants to take a distribution from the plan. How is this sleight of hand accomplished? By permitting an *in-plan* Roth direct rollover from a particular account while not otherwise permitting a distribution from the account. For example, a plan that does not currently allow for in-service distributions from participants' profit sharing contribution accounts may be amended to permit in-plan Roth direct rollovers from these accounts by participants who have been in the plan for at least five years, while not permitting the participant to remove these amounts from the plan unless and until he/she is eligible for some other type of distribution (e.g., upon severance of employment).

D. – In-Plan Roth Conversions May Not Be Reversed

Employers considering adding an in-plan Roth conversion to their plans should bear in mind that, in contrast to Roth IRA conversions, Roth conversions in a qualified 401(k), 403(b), or 457(b) plan cannot be reversed (or, to use the technical term, "recharacterized") if the participant later decides he/she is unhappy with the conversion. An election under the new in-plan Roth conversion feature is like joining the Mafia – once you're in, you're in for good.

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[1] Technically, the Code permits in-service distribution of employer contributions upon a participant's attainment of a "specified age" or the occurrence of a "specified event." The IRS has provided little guidance on what these terms mean. The IRS has provided two examples of what constitutes a "specified event": (i) the participant's completion of five years in the plan or (ii) the distributable amount having been held in the plan for at least two years. But the meaning of "specified age" has been left entirely opaque. Some plan sponsors have been extremely aggressive and allow for in-service distributions upon attainment of the plan's minimum participation age (usually 18 or 21). This approach effectively makes all vested employer matching and nonelective contributions *immediately* distributable (and convertible). But this approach, in our judgment, needlessly invites IRS scrutiny and is not without risk.

E. – <u>Early Distribution Penalty on Funds Withdrawn from Roth Conversion Account</u>

Another cautionary note for those employers interested in adopting an in-plan Roth conversion feature is the early distribution and special recapture penalties.

Early Distribution Penalty. In general, as noted in Part I above, a participant is subject to a 10% penalty tax on the earnings in his/her Roth account if he/she receives a distribution from the Roth account before attaining age 59½. There are multiple exceptions to this rule: distributions after a participant's death or disability are not subject to this tax, nor are distributions that follow a participant's separation from service after attaining age 55. Distributions that are timely rolled over to an IRA or to another qualified plan are also exempt from this penalty. The penalty, if it applies, is equal to 10% of the taxable amount of the distribution. For example, if a participant receives a $50,000 distribution to which no exception applies, but only $10,000 is taxable (i.e., only the $10,000 in earnings is taxable), the penalty would be $1,000.

Recapture Penalty. Separate and apart from the early distribution penalty on the earnings in a Roth account is a recapture penalty that applies if a participant takes a distribution of his/her Roth conversion account within a five-year period that includes the date of conversion. (The five-year period begins January 1 of the calendar year in which the participant made the in-plan Roth conversion and ends on December 31 of year five.) The recapture penalty is equal to 10% of the participant's basis in his/her Roth account. To understand how all this works, consider the example below:

Assume that participant Paul, who is age 45, receives a $50,000 distribution from his pre-tax (non-Roth) account in his employer's 401(k) plan on March 3, 2011. Although the plan allows Roth deferrals, Paul has never made any. If Paul does not roll over this distribution, he will be subject to a 10% tax on the $50,000. However, Paul opts to roll over this $50,000 distribution into a designated Roth account pursuant to an in-plan Roth conversion (as allowed by the plan). In doing so, Paul now must include the $50,000 in his 2011 taxable income, but he avoids any 10% penalty for early distribution.

The five-year period for determining whether Paul's designated Roth account is subject to any recapture penalty (a time period referred to as the "recapture period") runs from January 1, 2011 through December 31, 2015. (This happens to be the same five-year period, which was discussed in Part I above, for determining if Paul's ultimate distribution from the Roth account is a "qualified" distribution.) In other words, if Paul waits until at least January 1, 2016, to take a distribution from his Roth account, he will not pay any taxes whatsoever on the distribution.

If, however, Paul takes a distribution from his Roth account prior to January 1, 2016, he will be subject to the recapture penalty. So let's assume in our example that Paul takes a distribution of his Roth account on February 1, 2014, and his account at that time is worth $60,000 (an amount consisting solely of the $50,000 in-plan Roth conversion and $10,000 in earnings thereon). Rather than rolling over the distribution, Paul buys a new, fully-loaded sports car. In these circumstances, the following would occur:

- Paul will have to include the $10,000 in earnings as part of his ordinary income in 2014 because his Roth account was distributed before he attained age 59½ and no exception applied;

- Paul will have to pay a 10% early distribution penalty on the $10,000 of earnings in his account (i.e., the taxable amount of his distribution), which will be equal to $1,000;

- Paul will also have to pay a 10% recapture penalty on the $50,000 of the distribution that represents the basis in his Roth account (i.e., a penalty of $5,000) since he took a distribution of his designated Roth account before the five-year recapture period had expired; and

- Paul will have a very unhappy wife.

F. – Deadline for Amending Plan to Adopt In-Plan Roth Conversion Feature

Employers wishing to adopt an in-plan Roth conversion feature in their qualified plans must amend their plan document. The deadline for amending a *non-safe harbor* 401(k) plan is ordinarily the *last* day of the plan year in which the conversion feature was added. The deadline for amending a *safe harbor* 401(k) plan is ordinarily the *first* day of the plan year in which the conversion feature is to take effect. A special rule exists, however, for plans that are amended in 2011; for *all such plans* – whether calendar or fiscal year – the deadline for adopting an in-plan Roth conversion feature is December 31, 2011.

The deadline for amending a 403(b) plan depends on whether the plan will be subject to an extended "remedial amendment period." A 403(b) plan will be subject to an extended remedial amendment period only if it adopts a plan that is pre-approved by the IRS (such as a prototype plan) or applies for an individual determination letter from the IRS. The IRS does not currently have a program under which 403(b) plans can be pre-approved or receive individual determination letters, but it has stated that it plans to open such programs in the near future. If the 403(b) plan is subject to the extended remedial amendment period, the amendment deadline will be the later of (a) the end of the remedial amendment period or (b) the last day of the plan year in which the conversion feature was added. If this remedial amendment period is *not* available to the 403(b) plan, the amendment will need to be adopted by the last day of the plan year in which the conversion feature is added.

We are still awaiting guidance from the IRS for amending 457(b) plans.

The time deadlines set forth above apply to amendments to add the in-plan Roth conversion feature, to add a distribution option to the plan in connection with the conversion, or to permit elective deferrals to be designated as Roth contributions. However, the extension does not apply to an amendment to add a 401(k) cash or deferred arrangement to an existing plan.

III. – CONCLUSION

Although the rules governing in-plan Roth conversions can be confusing, and the feature may not appeal to every employer, Roth conversions within a qualified plan can be an excellent tax-saving device. Employers sponsoring 401(k), 403(b), and 457(b) plans, therefore, may wish to seriously consider adding this component to their plans in order to provide participants greater flexibility in their retirement planning.

If you have questions regarding the new in-plan Roth conversion provisions or any other aspect of your qualified plan, please feel free to call Eric Namee, Steven Smith, or Brad Schlozman at (316) 267-2000.