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Retirement PLAN news

In-plan Roth rollover rules

Late in 2010, the IRS issued guidance for in-plan Roth rollover provisions for 401(k), 403(b), and governmental 457(b)* plans. This guidance answers many of the questions that have arisen regarding the implementation, ongoing administration, and reporting of this new plan option.

The in-plan Roth rollover conversion gives participants who want a Roth account the option of converting plan money to a Roth account within the plan, rather than rolling it over to a Roth individual retirement account (IRA). The guidance (Notice 2010-84), although issued very late in 2010, is helpful. It consists of 20 questions and answers that clarify the conversion rules.

Conversion methods

An in-plan Roth conversion can be accomplished by either a direct rollover into a designated Roth account or by distributing the funds to a plan participant who then rolls over the funds into a designated Roth account within 60 days.

Eligible participants

In addition to active plan participants, a surviving spouse beneficiary or an alternate payee who is a spouse or ex-spouse (under a qualified domestic relations order) may also elect an in-plan Roth rollover. Note that nonspouse beneficiaries may not elect the in-plan Roth rollover, but may convert funds via direct rollover to an inherited Roth IRA.

Additional requirements

For an in-plan conversion, there must be a distributable event that qualifies as an eligible rollover distribution. To provide employees with this option, the plan must permit in-service withdrawals. If a plan does not currently offer in-service withdrawals, it can be amended to add such withdrawals solely for the purpose of allowing in-plan Roth rollovers, while preventing employees from taking other types of in-service withdrawals.

Special tax notice

The Section 402(f) notice provides a description of the tax consequences of a plan distribution.

Plans that adopt the in-plan Roth rollover provision must update their 402(f) notice to include a written explanation of the in-plan Roth conversion feature and provide the notice to individuals who request a distribution that is eligible for rollover. Notice 2010-84 includes IRS model language that can be added to existing 402(f) notices.

Conversions that aren't distributions

Although in-plan Roth rollovers are treated as distributions for tax purposes, they are not treated as distributions in the following situations:

- A plan loan transferred to the designated Roth account (without changing its repayment schedule) is not treated as a new loan.
- Spousal consent is not required in connection with an election to make an in-plan Roth rollover.
- The amount rolled over is taken into consideration in determining whether a participant's accrued benefit exceeds $5,000 (for purposes of determining whether a subsequent involuntary cash-out distribution may be made).

* The in-plan Roth rollover provision became effective for governmental 457(b) plans on January 1, 2011.

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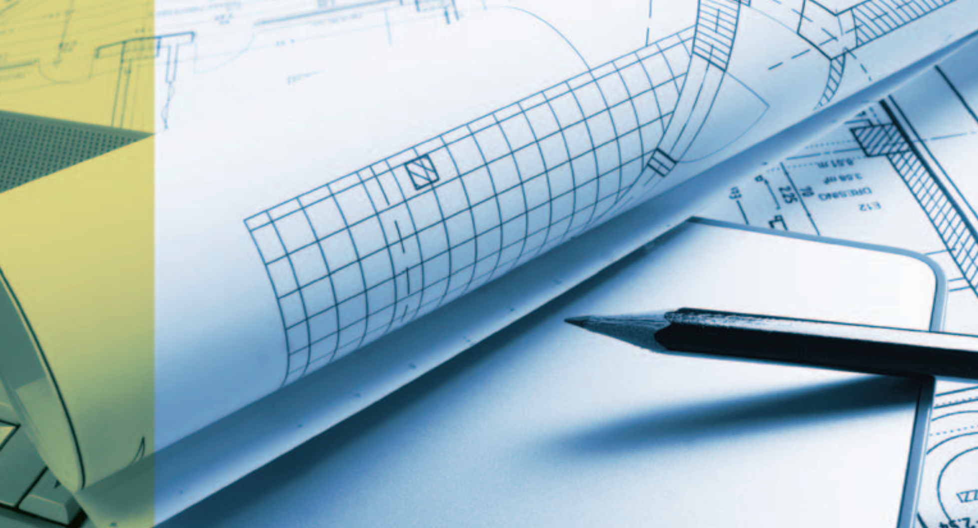


Safe harbor

401(k) plan design issue

For a plan to be "safe harbored" from (i.e., avoid) performing the actual deferral percentage (ADP) test, all eligible nonhighly compensated employees (NHCEs) who worked at least an hour during the year must receive a safe harbor contribution. For example, if the plan is using the guaranteed 3% nonelective contribution (NEC) safe harbor, the NEC must be provided to all eligible NHCEs, even those who were eligible to defer but never did.

No allocation requirements are permitted on the safe harbor contribution. Therefore, the NEC must be provided to those NHCEs who left before performing 500 or 1,000 hours of service during the year and those who did not work on the last day of the year.

Regulations and the plan document

The regulation stipulates that only NHCEs must receive the safe harbor contribution; it does *not* require that highly compensated employees (HCEs) receive the safe harbor contribution. However, the plan document is another issue. Plan provisions ultimately govern who is to receive an allocation.

Excluding HCEs

To provide the safe harbor contribution *only* to NHCEs, the plan document must be drafted with a provision that excludes the HCEs from receiving safe harbor contributions. Generally, this may be accomplished by excluding HCEs from the safe harbor contribution in the plan's eligibility section.

Note: Such a provision must be adopted before the beginning of the plan year for which the HCEs are to be excluded. Once the plan year has started, HCEs may not be excluded from the current plan year's safe harbor contribution.

Including HCEs

Alternatively, a plan sponsor may want to provide the safe harbor contribution to *all* eligible employees, including HCEs, and that is permitted. If there is no provision in the plan document excluding HCEs, then they also must receive the safe harbor contribution.

In-plan Roth rollover rules

(Continued from page 1)

- A participant who had the right to a distribution prior to electing an in-plan Roth rollover cannot have that right eliminated after electing such a rollover.

Roth contribution program

To permit in-plan Roth rollovers, a 401(k), 403(b), or governmental 457(b) plan must have a qualified Roth contribution program in place at the time the rollover provision becomes effective. According to IRS guidance, having a qualified Roth contribution program in place means the plan already offers a Roth salary deferral option.

A plan may be amended retroactively to add a qualified Roth contribution program. However, to take advantage of the special tax treatment for Roth conversions in 2010, the qualified Roth contribution program had to have been in place at the time of the conversion.

Amendment deadline extended

The deadline for an employer who sponsors a 401(k) plan to adopt an in-plan Roth rollover amendment has been extended to the *later of* the last day of the year in which the amendment is effective or December 31, 2011. The amendment must be effective retroactive to the date the plan first permits in-plan Roth rollovers.

The deadline extension also applies to amendments that:

- Add in-plan Roth rollovers
- Allow designated Roth accounts to accept rollover contributions
- Permit in-service distributions for in-plan Roth rollovers only

Amendment adoption

The provisions relating to the amendment details of permitting in-plan Roth rollovers may be adopted administratively and summarized in a board resolution that authorizes the plan's amendment. Those provisions will subsequently be formally set forth in a model amendment that is adopted before the expiration of the remedial amendment period.

Administrative note: A separate designated Roth sub-account should be established for in-plan Roth conversions in order to appropriately apply the recapture tax or acceleration of income rules.

In-plan Roth rollover and tax issues

The tax law that created the in-plan Roth rollover also established an optional tax break for conversions completed in 2010. Participants have until their tax-filing deadline to decide how to pay the income tax due on any 2010 in-plan Roth rollover amounts.

Tax basics

Pretax amounts included in an in-plan Roth rollover are taxable in the year distributed. Amounts directly rolled over are *not* subject to the 20% mandatory federal income-tax withholding or the 10% early withdrawal penalty for participants under age 59½. Amounts distributed to the participant and rolled over under the 60-day rule are subject to mandatory 20% withholding requirements.

If the distribution includes an outstanding loan, the current loan balance is also included as income. If the distribution includes any employer securities, the fair market value to be taxed includes any net unrealized appreciation.

Special two-year tax method

For conversions made in 2010 only, participants have the option of paying the income tax due on their 2010 tax return or splitting the amount and paying half in 2011 and half in 2012. An individual election to include the in-plan Roth rollover as income in 2010 cannot be changed after the filing due date (including extensions) of the individual's 2010 tax return.

An election made with respect to taxes due on an in-plan Roth rollover is independent of any election made with respect to taxes due on a conversion to a Roth IRA from a non-Roth IRA or plan account other than a designated Roth account. Thus, a participant could pay the taxes due on an in-plan Roth rollover completed in 2010 using the special two-year tax method, while paying the taxes due on funds converted from a plan to a Roth IRA in full in 2010 — or vice versa.

The employer's reporting responsibility is limited to the preparation of the appropriate Form(s) 1099-R for the year in which the in-plan Roth rollover occurs.

Note that, in late December 2010, Congress enacted legislation retaining the income-tax brackets that were due to expire on December 31, 2010. Thus, an individual who did not complete an in-plan Roth conversion in 2010 may simulate the two-year tax method by rolling over half the total amount he or she wishes to convert in 2011 and half in 2012.

No recharacterization permitted

When funds are converted from a traditional IRA to a Roth IRA, individuals have the option of "undoing" or recharacterizing the conversion as long as the recharacterization is completed by the individual's tax-filing deadline (including extensions). Such recharacterization is not permitted with in-plan Roth conversions.

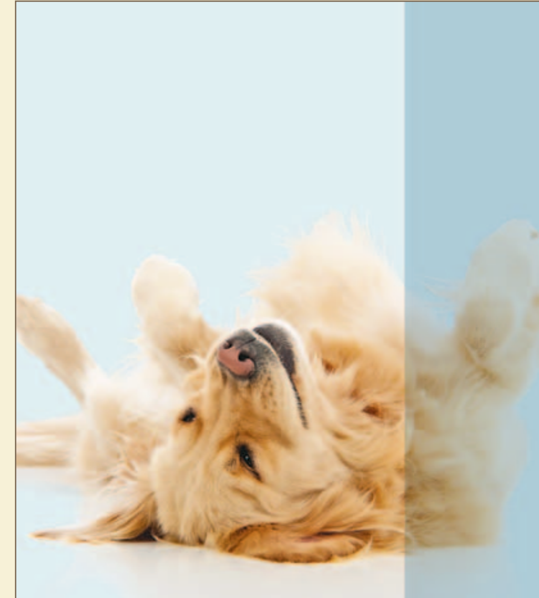
Income acceleration

Those who completed an in-plan Roth conversion in 2010 and chose the two-year tax payment method should be aware of the following: If any of the amounts converted are distributed prior to the tax payment due date under that election, acceleration of income will apply for tax purposes.

Example: An individual converted $12,000 in 2010 and elected the two-year tax treatment. In 2011, he withdraws $4,000 of the converted amount. The $4,000 becomes immediately taxable in 2011 in addition to the $6,000 that is already scheduled to be taxed in 2011, resulting in a total taxable amount in 2011 of $10,000. The remaining $2,000 is taxed in 2012.

The recapture tax

If a converted amount is withdrawn within five years of the conversion (as in the example just given) and the individual is under age 59½, a 10% penalty tax will



apply on the amount withdrawn. The five-taxable-year period for determining whether the recapture tax applies starts the first day of the participant's tax year in which the in-plan Roth conversion occurred. For most taxpayers, this is usually January 1. It ends on the last day of the individual's fifth taxable year after the conversion.

The designated Roth five-year clock

The five-year clock for designated Roth accounts starts on the first day of the calendar year in which the earliest of the following occurs:

- An in-plan Roth conversion, or
- The first designated Roth contribution, or
- A direct rollover of designated Roth contributions from a prior employer's plan with an earlier contribution starting year

Thus, if the participant already has designated Roth deferrals in the plan at the time of an in-plan Roth conversion, the five-year clock is already running. It does not start over for the in-plan rollover amounts. Note: This applies only to the five-year requirement for tax-free earnings. The five-year period for recapture tax purposes (discussed above) must be tracked separately.

RECENT developments

Proposed changes to fiduciary definition

Late in 2010, the DOL issued proposed regulations that would expand the definition of persons who are considered fiduciaries under Section 3(21)(A)(ii) of ERISA. This section of ERISA relates specifically to individuals who become fiduciaries by providing investment advice for a fee. The regulation defining fiduciary status has not been updated since it was originally issued in 1975 when ERISA covered mostly defined benefit plans and employer directed defined contribution plans.

The DOL recognizes that changes to broaden the definition are necessary to accommodate the growing number of participant-directed individual account plans, changes in the financial industry, and the expectations of plan officials and participants for protection against certain conflicts of interest and abuse. The regulations would become effective 180 days after being published as final regulations in the Federal Register.

Qualified charitable donations from IRAs

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 has extended the qualified charitable donation (QCD) from individual retirement accounts (IRAs) through tax years 2010 and 2011. The QCD was originally created under the Pension Protection Act of 2006 for the 2006 and 2007 tax years and then extended to tax years 2008 and 2009 by the Emergency Economic Stimulus Act in late 2008. QCDs allow individuals age 70½ or older to make nontaxable distributions of up to $100,000 from an IRA (other than a SEP or SIMPLE IRA that is receiving ongoing employer contributions) to organizations eligible to receive tax-deductible contributions. Distributions must be made directly by the IRA trustee(s). (**Note:** H.R. 4853 permitted 2010 QCDs until January 31, 2011.)

DB amendment deadline extension

The IRS extended the deadline for amending qualified defined benefit plans to meet certain requirements added by the Pension Protection Act of 2006 from the end of plan year 2010 to the last day of the first plan year that begins on or after January 1, 2011. The original deadline was the end of plan year 2009. The extension applies to the deadline for amending single-employer defined benefit plans to meet requirements related to funding-based limits on benefits and benefit accruals under single-employer plans (Sections 401(a)(29) and 436). It also applies to the deadline for amending cash balance and other applicable defined benefit plans for changes related to vesting and other special rules (Section 411(a)).

The general information in this publication is not intended to be nor should it be treated as tax, legal, or accounting advice. Additional issues could exist that would affect the tax treatment of a specific transaction and, therefore, taxpayers should seek advice from an independent tax advisor based on their particular circumstances before acting on any information presented. This information is not intended to be nor can it be used by any taxpayer for the purpose of avoiding tax penalties.

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