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New Law Permits "In-Plan" Roth Conversions

A new law now permits amounts to be converted within certain retirement plans to separate after-tax Roth accounts held under the plan. This new law makes it easier for participants to take advantage of a special tax rule that takes effect in 2010. Companies that wish to allow "in-plan" Roth conversions to take advantage of the special 2010 tax rule will need to take action before year end.

Special 2010 Tax Rule for Roth Conversions

- Beginning in 2010, taxpayers may convert all or a portion of a traditional IRA to an after-tax Roth IRA, without regard to the taxpayer's adjusted gross income. For tax years before 2010, such conversions were not permitted if the taxpayer's adjusted gross income exceeded certain dollar limits (i.e., \$100,000).
- In addition, under a special tax rule effective only in 2010, taxpayers who elect to convert all or a portion of a traditional IRA to an after-tax Roth IRA in 2010 may choose to include the converted amount in income in 2010 or include half the converted amount in income in 2011 and the balance of the converted amount in 2012.
 - If no election is made, amounts converted to a Roth IRA in 2010 will be includible in income ratably in 2011 and 2012.
 - If converted amounts are distributed from the Roth IRA before 2012, income inclusion for distributed amounts will be accelerated.
- These special tax rules were enacted in 2006 and became effective in 2010.

New Law Extends Special Tax Rules to "In-Plan" Roth Conversions

- The recently enacted Small Business Jobs Act of 2010 (the "Act") now permits sponsors of certain retirement plans to allow plan participants to transfer certain amounts held under the plan into separate Roth accounts held under the plan. This new feature is often referred to as an "in-plan" Roth conversion. Before the Act was passed, in-plan Roth conversions were not permitted.
- The special 2010 income averaging tax rule applies to in-plan Roth conversions.

Requirements for "In-Plan" Roth Conversions

To permit "in-plan" Roth conversions, each of the following requirements must be met:

- the plan must be an Internal Revenue Code § 401(k) plan, § 403(b) plan or, starting in 2011, governmental § 457(b) plan;
- the plan must have a designated Roth account feature that permits participants to make Roth after-tax contributions;

- the amount to be converted must be "immediately distributable" under the plan (amounts are generally immediately distributable when a participant reaches normal retirement age, terminates employment or incurs another distributable event or takes an in-service withdrawal permitted under the plan); and
- the amount to be converted must qualify as an "eligible rollover distribution" within the meaning of Internal Revenue Code § 402(c).

Plan Amendments May Be Required

- Plan sponsors that wish to offer "in-plan" Roth conversions must amend their plan documents to specifically permit "in-plan" Roth conversions.
- Sponsors of plans that do not currently provide for Roth after-tax contributions may be amended to add a designated Roth account feature.
 - Such amendments cannot be limited to "in-plan" Roth conversions. The amendments must also permit participants to make after-tax contributions to the plan's Roth account.
- To permit more participants to take advantage of "in-plan" Roth conversions, plan sponsors may amend plan documents to provide for additional distributable events or in-service withdrawal provisions.
- Plan sponsors may limit the new distribution and in-service withdrawal options so they apply only to "in-plan" Roth conversions.
- Plan sponsors that wish to permit "in-plan" Roth conversions in 2010 to allow participants to take advantage of the special 2010 income averaging rule must amend their plans to provide for "in-plan" Roth conversions, but Treasury officials urge plan sponsors to await further guidance from the IRS before making any plan amendments, as the IRS may issue model amendments, announce a remedial amendment period, and publish additional guidance on "in-plan" Roth conversions.

"In-Plan" Roth Conversions Are Optional

- The new "in-plan" Roth conversion provision is optional. Plan sponsors are not required to allow participants to make "in-plan" Roth conversions.
- Plan sponsors should weigh the pros and cons of adding an "in-plan" Roth conversion feature, such as the costs of administration needed to implement such a feature, and how many participants are likely to take advantage of the feature.
- Plan sponsors should consult with the plan's outside recordkeepers and third party administrators to ensure that the recordkeeper or third party administrator will be able to implement and administer the "in-plan" Roth conversions before year end.

New Option for Governmental § 457(b) Plans

- The Act also permits sponsors of governmental § 457(b) plans to add designated Roth accounts to their plans in taxable years beginning after 2010, and then these plans can be amended to allow "in-plan" Roth conversions if the conditions described above are met.
- This option is not available to governmental § 457(b) plans before 2011.

Our client alerts are for general informational purposes and should not be regarded as legal advice. If you would like additional information or have any questions, please contact:

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