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IRS Issues Guidance on In-Plan Roth Rollovers

The Internal Revenue Service (IRS) has issued Notice 2010-84 which allows plan sponsors to adopt, even after December 31, 2010, amendments providing for 2010 in-plan Roth conversions. The notice also addresses the tax rules governing in-plan Roth conversions.

Background

The Pension Protection Act of 2006 (PPA) permits an individual to roll over an eligible rollover distribution under Internal Revenue Code (Code) Section 402(c)(4) that is received from a qualified plan directly into a Roth IRA. The individual is immediately taxed on the taxable portion of the distribution as if the distribution had not been rolled over to an IRA. In the case of a plan distribution received in 2010 that is rolled over to a Roth IRA, a special rule applies. The 2010 distribution is taxed as if half of it was received by the taxpayer in 2011 and the remaining half received in 2012 unless the participant elects to have the full amount treated as received in 2010.

> ***BUCK COMMENT.*** *The ability to convert distributable non-Roth amounts in 401(k) and 403(b) plans to Roth IRAs by paying current tax on the distribution offers attractive estate-planning options for some individuals. The ability to split the tax between 2011 and 2012 by taking the distribution in 2010 provides further tax-planning opportunities. The consequence of the PPA provision was an incentive for some individuals to take their money out of the 401(k) or 403(b) plan in order to take advantage of these opportunities. In order to provide the same tax benefits, but allow the amounts to remain in the 401(k) or 403(b) plan, the Small Business Jobs Act of 2010 (SBJA) permits an in-plan Roth rollover with many of the same tax benefits.*

Under SBJA, after September 27, 2010, a participant is able to elect to transfer his or her vested non-Roth amounts accumulated in a 401(k) or 403(b) plan into his or her designated Roth account under the same plan if the plan and the distribution satisfy certain requirements. (Starting in 2011, this option will also be available for governmental Section 457(b) plans.) The plan must have in place an initial deferral choice between a traditional pre-tax election and a Roth election and must provide for the in-plan Roth rollover distribution option. The in-plan Roth rollover may occur only if the individual could have received a distribution from the plan and rolled it over to an IRA or other eligible plan at the time of the in-plan rollover.

Notice 2010-84

Notice 2010-84 clarifies the tax rules governing in-plan Roth rollovers and provides that a plan may allow participants to receive distributions in 2010 and retroactively make the necessary amendments later.

Tax Treatment

As in the case of a 2010 distribution rolled over to a Roth IRA, a 2010 in-plan Roth rollover is treated as distributed half in 2011 and half in 2012 unless the participant elects for 2010 treatment. This special two-year delayed tax treatment is not available for distributions after 2010. Unlike a rollover to a Roth IRA, a participant who rolls over his or her distribution in an in-plan Roth rollover may not "recharacterize" (i.e., unwind) the in-plan rollover retroactively. Mandatory withholding of 20% of the taxable distribution does not apply to in-plan Roth rollovers.

A plan must separately account for the in-plan Roth rollover amounts. Upon a distribution, tax treatment will depend on the relative amount that is allocable to the in-plan Roth rollover account as opposed to the Roth elective deferrals account. If there is a distribution from the plan in 2010 or 2011 of an amount allocable to the in-plan Roth rollover, there may be an acceleration of the taxation of the taxable amount of the distribution to 2010 (from 2012 and 2011) or 2011 (from 2012). Further, a distributed amount allocable to the taxable amount of an in-plan Roth rollover is subject to the 10% additional tax under Code Section 72(t) for premature distributions (unless an exemption applies) if the distribution occurs within the five-taxable-year period beginning with the first day of the year of the in-plan Roth rollover.

Distribution Rules

Under the Code, an in-plan Roth rollover is treated as a distribution from the plan for certain purposes but not for others. According to Notice 2010-84,

- A plan loan transferred unchanged as part of an in-plan Roth rollover is not treated as new loan,
- An in-plan Roth rollover is not a distribution for purposes of the spousal consent requirements,
- The amount rolled over to the Roth account is still counted for purposes of determining whether the value of the participant's accrued benefit exceeds $5,000, and
- The in-plan Roth rollover does not eliminate any right the participant has to elect an immediate distribution.

An in-plan Roth rollover is considered a distribution for purposes of the Code Section 402(f) eligible rollover distribution notice. Thus, a plan that offers in-plan Roth rollovers must include a description of the tax implications of the rollover option in its Code Section 402(f) notice and provide that notice in a timely manner to an affected individual. The guidance provides sample language that a plan sponsor may use to describe the in-plan Roth rollover option.

Availability of Roth Deferral

A plan may not provide for an in-plan Roth rollover unless the plan provides a participant with the option to make initial deferrals to a Roth 401(k) or Roth 403(b) account. Thus, a plan may permit the in-plan Roth rollover in 2010 only if it provides for, or is amended to provide for, initial deferrals to a Roth account for some part of 2010. Under the guidance, the IRS allows the employer to amend the plan retroactively to satisfy this condition by –

- amending a profit sharing plan without a 401(k) component or a 403(b) plan without elective deferrals to establish a program permitting elective deferrals,
- adding a Roth deferral option to a plan that has an existing pre-tax 401(k) or 403(b) elective option, or
- both.

The ability to amend retroactively is conditioned on the plan operationally making the Roth election available before the end of 2010. The sponsor must adopt the retroactive amendments by December 31, 2011 in the case of a 401(k) plan; the amendment date of a 403(b) plan is discussed below.

BUCK COMMENT. *As long as an employee is eligible in 2010 to defer some part of 2010 compensation to a Roth account, the sponsor may make the 2010 in-plan Roth rollover option available with respect to any money in the plan eligible to be distributed and rolled over under the provisions of the plan and the Code.*

Availability of Distribution/Rollover Option

Amounts in defined contribution plans are subject to various restrictions on distributions. In general, a plan may distribute 401(k) amounts only when the employee separates from service, attains age 59½, dies, or becomes disabled. Some non-401(k) amounts, such as profit-sharing contributions, are not prohibited from being distributed while the employee is still working and not yet age 59½. In-plan Roth rollovers are permitted only with respect to amounts that are eligible to be distributed from the plan and rolled over. Similar, but slightly different rules apply for 403(b) plans. The notice clarifies that, if the Code permits the plan to make a distribution, the plan may limit the distribution option to be solely for purposes of the in-plan Roth rollover and not allow a distribution for any other purpose.

Normally the employer would have to amend the plan to provide for such distributions in 2010 by the end of the 2010 plan year. However, the notice provides remedial relief so that the employer need not make the 2010 amendment to a 401(k) plan until December 31, 2011, as long as the amendment is retroactively effective to the date rollover distributions were first allowed under the plan. (The 403(b) amendment date is discussed below.)

Safe-Harbor 401(k) Plans

A sponsor of a 401(k) plan can avoid having to test the plan for nondiscrimination if the plan provides that all non-highly compensated employees will receive a specific minimum nonelective contribution or provides that non-highly compensated employees that defer compensation will receive a specific minimum matching contribution. The employer may generally not amend these safe-harbor plans after the first day of the plan year. The notice provides that sponsors do not have to adopt amendments to these safe-harbor plans for purposes of the in-plan Roth rollover until the later of December 31, 2011 or the time otherwise specified in law for such plan amendments. The amendment will have to be retroactive to the date the provision was implemented.

Special Rules for 403(b) Plans

The retroactive amendment rules applicable to 401(k) plans also apply to 403(b) plans, but the remedial amendment period is different. The general remedial amendment period for 403(b) plans has not yet closed. No amendment is required for a 403(b) plan until the open remedial amendment period ends (an uncertain date at this time) so long as the plan operates in accordance with the eventual amendment and the amendment is retroactive to such date.

> ***BUCK COMMENT.*** *The IRS is establishing a master and prototype plan program for 403(b) plans and eventually an individual determination letter program. The remedial amendment period runs, absent new guidance, until the time the applicable program is established.*

Conclusion

Notice 2010-84 is aimed at permitting those employers who want to allow their employees to be able to do in-plan Roth rollovers in 2010 to take advantage of the special tax treatment to do so.

Buck's consultants are available to answer your questions regarding this provision and assist you in drafting related plan amendments and participant communications.