

In-Plan Roth Rollovers – New Tax Planning Opportunities

The Small Business Jobs Act of 2010 ("SBJA"), in addition to offering tax breaks for small businesses, provides two new provisions involving Roth contributions and rollovers to Roth accounts under employer qualified plans, such as Internal Revenue Code ("Code") Section 401(k) plans and Code Section 403(b) plans.

Background

Roth Contributions

Section 401(k) plans and Section 403(b) tax-deferred annuity plans may include a "designated Roth program" under which a participant is permitted to designate all or a portion of his or her elective salary reduction contributions as a designated Roth contribution in lieu of treating such contributions as a pre-tax elective deferral. The amount so treated as a designated Roth contribution, unlike a pre-tax elective deferral, will be included in the employee's gross income at the time it is contributed to the plan. The aggregate amount of designated Roth contributions and pre-tax elective deferrals made by an employee for any calendar year may not exceed the dollar limit that otherwise applies under the Code to elective deferrals for such year (e.g. \$16,500 for 2010 and 2011, which amount may be increased for applicable "catch up" limits, and is subject to future cost of living adjustments).

Roth Separate Accounting and Roth Distributions

All designated Roth contributions must be credited to a separate designated Roth contribution account for each participant under the plan. Separate recordkeeping must be maintained for designated Roth contributions and the earnings attributable to such amounts.

A distribution from a designated Roth account that constitutes a "qualified distribution" is excluded entirely from the recipient's income at that time. Thus, in the case of a qualified distribution, the earnings attributable to the Roth contributions are not taxable to the recipient. A qualified distribution is a distribution under a plan from a designated Roth account that is made after the participant attains age 59½, dies or becomes disabled and after a required five-year period has elapsed measured from the calendar year for which the participant first makes a designated Roth contribution under such plan. A distribution from a designated Roth account that does not constitute a qualified distribution will be includible in income to the extent attributable to the earnings portion of the distribution and may be subject to a 10% additional tax on early distributions.

Roth Rollover Distributions

Currently, a distribution from a qualified plan, 403(b) tax-deferred annuity or eligible governmental Code Section 457(b) plan of amounts that have not yet been included in a participant's income ("pre-tax amounts"), and that qualifies as an "eligible rollover distribution," may be rolled over to another such plan or an IRA. In that case, the distribution will not be currently includible in the participant's income. Eligible rollover distributions are generally any distribution from such employer plans other than certain extended periodic payments (such as installments over ten years or more or life annuity payments), minimum required distributions, or hardship distributions.

Distribution from an employer retirement plan of "pre-tax amounts" may also be rolled over directly into a Roth IRA, without regard to previously applicable restrictions based on the income level of the participant. In the case of such rollover distributions, the amount rolled over, to the extent attributable to pre-tax amounts, is includible in the participant's income at that time.

With respect to a rollover from an employer plan to a Roth IRA that is made in 2010, such amount is not included in income for 2010, but instead will be included in the participant's income in equal amounts for the 2011 and 2012 taxable years, unless the participant elects to include the distribution in income in full for the 2010 taxable year. While normally deferring the payment of taxes is beneficial, whether a participant should defer the income recognition from such rollover distribution will need to be based on his or her personal tax situation (especially in light of the possibility of higher tax rates in future years). In other years, rollovers to a Roth IRA will be includible in income for the year in which the rollover occurs.

New SBJA Changes Affecting Roth Contributions and Roth Rollovers

Roth Contribution Option for Governmental 457(b) Plans

Commencing with taxable years beginning after December 31, 2010, governmental Code Section 457(b) plans, but not 457(b) plans maintained by non-governmental tax-exempt entities, may permit participants to make designated Roth contributions.

New In-Plan Roth Rollovers

Under the SBJA, effective for distributions made after September 27, 2010, if a 401(k) or 403(b) (or, beginning in 2011, governmental 457(b)) plan maintains a designated Roth contribution program, then a distribution from a participant's pre-tax accounts (i.e., account balances attributable to contributions that have not yet been included in the participant's income, including employee pre-tax contributions and employer contributions) may, if the plan so provides, be rolled over by the participant to a designated Roth account ***under the same plan***.

To effect such an "***in-plan***" Roth rollover, two important requirements must be emphasized. First, a plan must permit designated Roth contributions to be made if it desires to allow such in-plan Roth rollovers. Second, a distribution must be permitted under the plan and otherwise be an eligible rollover distribution. This latter requirement means the pre-tax account must be eligible for distribution at the time of the rollover, and thus, consideration must be given to any restrictions on distribution that would then apply (such as distribution restrictions applicable to pre-tax elective deferrals under a 401(k) or 403(b) plan, and plan or other legal limitations on making in-service distributions). The legislative history supporting this new in-plan Roth rollover provision, as well as IRS guidance described below (See **Recent IRS Guidance**) that interprets the in-plan Roth rollover feature, indicate that if an employer wishes to expand the participants' opportunity to make in-plan Roth rollovers, it may increase the distribution options under the plan, and if it does so, the plan may condition eligibility for such new distribution options on a participant's election to make an in-plan Roth rollover. Accordingly, such new distribution options can be limited to distributions made to effect an in-plan Roth rollover.

If a participant elects to make an in-plan Roth rollover of pre-tax accounts, then such rollover amount will be includible in the participant's income in the same manner as would apply to a rollover to a Roth

IRA. Thus, the rollover amount will be included in income for the year the rollover is made (except for the special two-year income inclusion spreading rule that applies for 2010 Roth rollovers).

The new in-plan Roth rollover option is effective for distributions made under the plan after the date of enactment of the SBJA (i.e., distributions made after September 27, 2010). If such in-plan Roth rollover option is offered (as well as the addition of a designated Roth contribution program, if necessary), plans will need to be timely amended to reflect such changes. (See **Recent IRS Guidance** below regarding the timing of plan amendments to implement an in-plan Roth rollover feature.)

Recent IRS Guidance

On November 26, 2010, the IRS issued guidance (**IRS Notice 2010-84**) regarding in-plan Roth rollovers. This guidance, in the form of questions and answers, confirms and clarifies the following points with respect to implementing and administering in-plan Roth rollovers under a 401(k) or 403(b) plan.

Eligible Rollovers and Participants.

- In-plan Roth rollovers may take the form of either a direct rollover or an "indirect" rollover (i.e., rollovers made within 60 days after a distribution from a non-Roth account under a plan). Once an in-plan Roth rollover is elected, the participant can not unwind it (i.e., it can not be recharacterized), as is the case with rollovers made to a Roth IRA.
- In addition to plan participants, beneficiaries who are surviving spouses and alternate payees who are the spouse or former spouse of the participant under a qualified domestic relations order are eligible to make in-plan Roth rollovers.

Distributions Eligible for In-Plan Roth Rollover.

- Plans may be amended to add a new distribution option consistent with applicable law, and may limit such new distribution option to only distributions that are rolled over in an in-plan Roth direct rollover. However, the addition of such limitation on an existing distribution option would be prohibited.

In-Plan Roth Direct Rollovers Not Treated as Distributions for Certain Purposes.

- A distribution rolled over in an in-plan Roth direct rollover is not treated as a distribution for purposes of: (i) plan loans, (ii) spousal consent (as applicable) to plan distributions, (iii) determining whether a participant's account exceeds \$5,000 (requiring participant consent before a distribution is made), and (iv) prohibition on eliminating distribution rights existing prior to the rollover. However, it appears that in-plan Roth "indirect" rollovers (i.e., rollovers made within 60 days of actual plan distribution) would be treated as distributions for purposes of the plan matters described in the preceding sentence.

Plan Amendments.

- Generally, a plan amendment adding an in-plan Roth rollover option must be adopted by the last day of the first plan year in which it is effective.
- IRS has extended the plan amendment deadline for implementing in-plan Roth rollovers in 2010 under 401(k) and 403(b) plans. The extended plan amendment deadline applies to amendments that (i) permit elective deferrals to be designated as Roth contributions, (ii) provide for acceptance

of rollovers to the designated Roth account, (iii) permit in-plan Roth rollovers, and (iv) provide for new forms of distribution that can be rolled over in an in-plan Roth direct rollover. The extended plan amendment deadlines are as follows:

- 401(k) plans must be amended by the later of the last day of the plan year in which the amendment is effective or December 31, 2011, provided the amendment is made effective retroactively to conform to the date the in-plan Roth rollover feature was implemented in operation.
- Safe harbor 401(k) plans must be amended by the later of the day preceding the first day of the plan year in which the 401(k) safe harbor plan provisions are effective or December 31, 2011.
- 403(b) plans must be amended by the later of the end of the plan's remedial amendment period as described in IRS Announcement 2009-89 (generally expected to be an extended period dependent on the employer's timely adoption of an IRS-approved prototype 403(b) plan or timely amendment and submission of its individually-designed 403(b) plan to the IRS for a determination letter) or the last day of the first plan year in which the amendment is effective, provided the amendment is made effective retroactively to the date the plan first operates in accordance with the amendment. The determination of the applicable remedial amendment period for the timely adoption of an in-plan Roth rollover amendment under a 403(b) plan is subject to additional IRS guidance to be issued in the future, and thus, such determination must await the issuance of such additional IRS guidance.

Taxation and Withholding.

- The taxable amount of a plan distribution that is rolled over in an in-plan Roth rollover is includible in income for the taxable year in which the distribution occurs.
- An in-plan Roth direct rollover is not subject to the 20% mandatory withholding tax requirement generally applicable to distributions that are eligible to be rolled over and that are not rolled over in a direct rollover. However, individuals who make in-plan Roth direct rollovers may need to increase their income tax withholding or make estimated tax payments to avoid tax underpayment penalties.
- In-plan Roth rollovers are not subject to the 10% additional tax on "early" distributions from a plan (i.e., generally distributions prior to age 59½).
- However, if the plan distributes any portion of the in-plan Roth rollover within a five-taxable year period (beginning on January 1 of the participant's taxable year in which the rollover was made), the taxable portion of the rollover that is so distributed is subject to the 10% early distribution tax, unless an exception to the early distribution tax applies or the distribution is rolled over to another designated Roth account or to a Roth IRA.

Special Tax Rules for 2010 In-Plan Roth Rollovers.

- Generally, the taxable amount of an in-plan Roth rollover is includible in income in full for the taxable year in which the distribution is made.
- In the case of in-plan Roth rollovers made in 2010, the participant will report one-half of the taxable amount in income in 2011 and the balance in income in 2012, unless the participant elects to include the entire taxable amount in income in 2010.

- An election to include the taxable amount in income for 2010 must apply to all in-plan Roth rollovers made in 2010, and such election may not be revoked after the due date (including extensions) of the participant's 2010 income tax return.
- Special income acceleration rules apply if the participant receives a distribution of any portion attributable to the taxable amount of the in-plan Roth rollover in 2010 or 2011 (i.e., prior to the taxable year the taxable amount would have been includible in income under the 2-year income spreading rule).

Tax Reporting and Notices.

- In-plan Roth rollovers under a 401(k) or 403(b) plan are reported on IRS Form 1099-R.
- Distributions from an in-plan Roth rollover account may need to be reported separately from other distributions under the Plan on a Form 1099-R.
- In-plan Roth rollovers should be accounted for separately from other Roth contributions so as to facilitate the tax reporting associated with in-plan Roth rollovers.
- If a plan offers an in-plan Roth rollover option, such option must be described in the distribution/rollover tax notice given to participants who are eligible to receive an eligible rollover distribution from the plan. The IRS guidance offers sample language that may be added to the distribution/rollover tax notice, often referred to as a "402(f) Notice," to satisfy this disclosure requirement.

Employer Considerations

Employers and plan sponsors can begin to consider whether to add an in-plan Roth rollover option to their plans. In determining whether to implement an in-plan Roth rollover option under an employer's 401(k), 403(b), or governmental 457(b) plan, the following points should be considered:

- Adding an in-plan Roth rollover option is voluntary, and thus not required. Consideration should be given to whether participants will find the ability to convert their pre-tax accounts to Roth after-tax accounts within the same employer plan beneficial from a tax or other non-tax standpoint.
- An in-plan Roth rollover option may keep money in the plan instead of having it rolled over to Roth IRAs. The plan's fiduciaries will then retain fiduciary responsibility for the rollover amounts that remain in the plan.
- Additional plan administration may be necessary if Roth rollovers are permitted within a plan, including additional recordkeeping responsibilities to reflect the new Roth rollover account and, if applicable, the new designated Roth contribution account program.
- Whether additional distribution options (in particular, in-service distribution options) should be offered to facilitate in-plan Roth rollovers, and if so, whether to limit such new distribution options to in-plan Roth direct rollovers. ♦

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