



Issue Brief

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THE IMPACT OF ROTH CONVERSIONS ON RETIREMENT PLANS

Roth contributions have received considerable attention in recent years due to the passage of several key pieces of legislation that increased their utility for participants in retirement plans. Most recently, President Obama signed into law H.R. 5297, the Small Business Jobs and Credit Act of 2010, which allows conversions from pre-tax accounts to Roth accounts within retirement plans (known as in-plan Roth conversions) and Roth contributions in governmental 457(b) plans.

Roth Contributions in Governmental 457(b) and Other Retirement Plans

Roth contributions are deferrals to retirement plans that the participant elects to include in gross income in the year the contribution is made. The benefit of making a Roth contribution is that investment earnings on Roth contributions not only accumulate on a tax-deferred basis, but are never subject to taxation if certain requirements are satisfied. The benefit of tax-free distributions has provided a significant incentive for participants to make Roth contributions.

Retirement plans are allowed, but not required, to permit participants to make Roth contributions. Section 401(k) and 403(b) plans have been allowed to include Roth contributions since 2006. Governmental 457(b) plans can allow participants to make Roth contributions beginning on January 1, 2011. Although the legislation expands Roth

contributions to governmental 457(b) plans, there has not been an expansion to the 457(b) plans of tax-exempt organizations.

Roth contributions are subject to the same contribution limits and nondiscrimination rules as pre-tax deferrals.

In-Plan Roth Conversions

As a result of the passage of the Small Business Jobs and Credit Act of 2010, in-plan Roth conversions are available for any 401(k), 403(b), or governmental 457(b) plans which accept Roth deferrals. These plans can allow amounts in pre-tax accounts to be converted to post-tax Roth accounts. Previously, retirement plan participants would have to rollover funds from a retirement plan to a Roth IRA to benefit from tax-free investment earnings. Now participants can keep the funds in their retirement plans and convert their pre-tax amounts to post-tax Roth amounts.

Participants pay tax on the amounts converted. For funds converted in 2010, the participant includes half of the taxable amount converted in 2011 and the other half in 2012 (unless the participant elects to include the full taxable amount in income in 2010). For all other years, the taxable amount is included in income in the year the funds are converted.

The following rules apply for in-plan Roth conversions:

- Participants can only make in-plan Roth conversions in plans that permit Roth contributions. The plan must operationally provide participants with the opportunity to make Roth contributions in order to allow in-plan Roth conversions. However, 401(k) and 403(b) plans can generally be amended to allow Roth contributions and/or in-plan Roth conversions until the later of December 31, 2011 or the last day of the plan year in which the feature is effective.
- The funds must be fully vested and otherwise eligible for a rollover distribution. Plans can add new rollover options to permit in-plan Roth conversions.
- In-plan Roth conversions are not treated as distributions for certain purposes. A plan loan that is transferred in connection with an in-plan Roth conversion will not be treated as a new loan if the repayment schedule is not changed. A married participant is not required to obtain his/her spouse's consent in order to elect an in-plan Roth conversion. Also, the amount rolled over in a conversion continues to be counted when determining whether the participant's accrued benefit exceeds \$5,000. Participants do not need to be notified of their right to defer receipt of the distribution as a result of the conversion. Participants who have distribution rights before the conversion do not lose these rights as a result of receiving a conversion. Additionally, the 20% mandatory withholding rules do not apply to these conversions.
- Participants cannot later unwind an in-plan Roth conversion. That is, a participant cannot re-characterize an amount that has been transferred to a Roth account back to a pre-tax amount.
- Surviving spouses as well as alternate payees who are spouses or former spouses can also elect in-plan Roth conversions.

Impact on Retirement Plans

Previously, a conversion to a Roth account was only available by moving money from a retirement plan to a Roth IRA. Many plan sponsors and participants were considering changes to permit workers to pull their retirement assets out of their plans. ASPPA had voiced public concern about the potential for workers who had no intention of converting to a Roth account cashing out their retirement accounts (known as "leakage").

ASPPA worked closely with members of Congress on the Roth conversion provision and applauds Congress for recognizing how this key change will preserve retirement savings. As a result of the Small Business Jobs and Credit Act of 2010, workers will not have to forfeit the protection and advantages of holding savings in an employer-sponsored retirement program to take advantage of special Roth conversion rules.

ASPPA also worked with both the U.S. Department of Treasury and the Internal Revenue Service (IRS) to share ideas on how to streamline the process for workers and practitioners. ASPPA was pleased that the IRS provided employers and retirement professionals with the necessary information in Notice 2010-84 to allow 2010 in-plan Roth conversions while protecting retirement savings.

"Thanks to guidance released by the Internal Revenue Service (IRS), employers and retirement professionals now have the necessary information to allow 2010 in-plan Roth conversions without permitting leakage of retirement savings."

-- ASPPA