



# Issue Brief

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## The Impact of Roth Conversions on Qualified Plans

### Roth Conversion Proposal

In 2006, Congress passed legislation that allows everyone regardless of income level to convert a traditional IRA to a Roth IRA starting in 2010. This conversion is taxable, and those who convert in 2010 can choose to recognize the income in 2010 or average it over the next two years (i.e., 2011 and 2012). Under current law, participants in 401(k) and 403(b) plans can transfer a distribution from their plan directly to a Roth IRA. However, participants cannot transfer amounts already built up in their accounts directly to a Roth account within the same plan.

Without a change in the law, participants who want the benefit of Roth account tax treatment (and the special income averaging rule for 2010 conversions) must take funds from qualified retirement plans prematurely in order to take advantage of the transfer feature through the use of a Roth IRA. To that end, plans are being amended (and in some cases terminated) to permit in-service withdrawals so that key employees can pull money out of qualified plans to take advantage of the Roth conversion through an IRA.

### Roth Accounts in Governmental 457(b) Plans

The Senate bill also would allow governmental 457(b) plans to include a qualified Roth contribution program (and in-plan Roth conversions) under which participants would be permitted to designate elective deferrals that could be otherwise deferred under the plan as Roth contributions. This provision would be effective for tax years beginning after December 31, 2010

To address this issue, the Senate included ASPPA's Roth conversion proposal in the American Workers, State, and Business Relief Act. This proposal would allow plans to offer participants the option of transferring an account balance that could be distributed without disqualifying the plan into the plan's Roth account, even if the plan does not permit actual distribution of the monies. This would avoid the need for participants to take a distribution if they want to convert their retirement funds from pre-tax to Roth status (and for plans to be amended to permit in-service distributions to enable these conversions).

### Congressional Movement

On March 10, the U.S. Senate passed the American Workers, State, and Business Relief Act of 2010 (H.R. 4213). This legislation includes ASPPA's Roth conversion proposal – a key priority of ASPPA's Government Affairs Committee. Our proposal would permit plans to offer conversion of otherwise distributable 401(k) and 403(b) account balances to a Roth account in the plan instead of requiring transfer to a Roth IRA to complete a conversion. The legislation also includes a proposal that would permit governmental 457(b) plans to include a qualified Roth contribution program. Now the focus will turn to the U.S. House of Representatives as they take up their own version of the bill. It is not clear whether the House bill will include the Roth provisions. However, ASPPA's Government Affairs Committee will be working very hard to ensure that the Roth proposals are included in the final bill when the Senate and House bills are merged during conference.

## Roth Account Direct Transfer Proposal

### Current Law:

- 401(k) and 403(b) plans can allow employees to make Roth contributions. Roth contributions are elective contributions that, unlike pre-tax elective deferrals, are currently taxable.
- Currently, employees participating in their company's retirement plan can transfer a distribution from their plan directly to a Roth IRA. However, participants cannot transfer amounts already built up in their accounts directly to a Roth account within the same plan.
- Plans can permit in-service withdrawals of any account balances after attainment of age 59 1/2. Employer contributions can be withdrawn after the contributions have been in the plan for two years, or after the individual has been a participant for at least 5 years.
- In 2006, Congress passed legislation that allows everyone regardless of income level to convert a traditional IRA to a Roth IRA starting in 2010. This conversion is taxable, and those who convert in 2010 can choose to recognize the income in 2010 or average it over the next two years (i.e., 2011 and 2012).

### The Proposal:

- The proposal would allow those participants entitled to take a distribution from their plan under current rules (e.g., a participant reaches age 59 1/2) to transfer the account balance that could be distributed into the plan's Roth account, even if the plan does not permit actual distribution of the monies. This would avoid the need for participants to take a distribution if they want to convert their retirement funds from pre-tax to Roth status (and for plans to be amended to permit in-service distributions to enable these conversions).
- The proposal also would allow 401(k) and 403(b) participants who are not entitled to take a distribution from their plan to transfer within the plan their existing elective deferrals and allocable earnings to a Roth account.

*"We're hopeful that with the Roth Conversion proposal, workers won't have to give up the advantages of an ERISA 401(k) plan to take advantage of the special 2010 Roth conversion rules. Without this proposal, many plans were considering changes that would make it easier for workers to take their retirement assets out of the plan. ASPPA is concerned about the potential for leakage out of retirement accounts for workers who had no intention of converting to a Roth account."*

— ASPPA

- Under both elements of the proposal, the amount transferred would generally be subject to ordinary income tax in the year the transfer is made. However, amounts transferred in 2010 would get the same special tax treatment as 2010 rollovers to Roth IRAs.

### Why This Proposal is Good Retirement Policy:

- These proposals will encourage workers to keep their retirement funds in their qualified retirement plans. Qualified plan accounts are subject to ERISA and therefore have greater participant and spousal protections than IRAs. ERISA requires employers to act prudently, diligently and with the highest regard for the interests of its employees when it comes to plan management and plan investing.
- Without this modification, participants who want the benefit of Roth account tax treatment will be encouraged to take funds from qualified retirement plans prematurely, in order to take advantage of the transfer feature that is currently only available through the use of Roth IRA accounts.
- Now that the Roth conversion is available through an IRA, plans are being amended (and in some cases terminated) to permit in-service withdrawals so that key employees can pull money out of qualified plans to take advantage of the Roth conversion through an IRA. These in-service withdrawals will be available to all participants – not just those moving the funds to an IRA – so the addition of in-service withdrawal provisions will encourage leakage from the retirement savings system. The proposal would eliminate the need to amend plans to permit in-service withdrawals, and the resulting leakage from the system.