Roth Conversions

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McKay Hochman Consulting, Provided by DST

Agenda

• Conversion Background
• In-plan Roth Conversions:
  – SBJA, Notice 2010-84
  – ATRA, Notice 2013-74
• Designated Roth and Roth IRA
• N. 2014-54: After-tax Contributions and Impact on IRRs and Roth IRA Rollovers
• Handling Plan Sponsor and Participant FAQs
• For Reference Form 1099-R Reporting
Conversion of Pre-Tax to Roth IRA

• Traditional IRA Conversion to Roth IRA as of 1998
  — AGI < $100,000; if married file jointly
  — 401(k) roll ➔ to traditional IRA ➔ convert to a Roth IRA

• 2008, 401(k) direct rollover ➔ to Roth IRA
  — AGI < $100,000; if married file jointly

• TIPRA* removed AGI as of 2010,
  — Leakage of 401(k) assets: individuals (mostly HCEs) able to do a conversion to a Roth IRA for the first time ever

*Tax Increase Prevention and Reconciliation Act of 2005

Conversion of Pre-Tax to 401(k) Roth

• From 2006 until September 27, 2010,
  — Pre-tax §401(k) balances were not allowed to be converted to a 401(k) Roth account.

• Small Business Jobs Act of 2010 created in-plan Roth Rollover conversion to designated Roth

• American Taxpayer Relief Act of 2012 created in-plan Roth Transfer as of 2013
Small Business Jobs Act of 2010
(SBJA)
September 27, 2010;
IRS Notice 2010-84

American Taxpayer Relief Act of 2012
(ATRA)
January 2, 2013;
IRS Notice 2013-74

SBJA: Conversion Only for Plans With Designated Roth Provision

- Conversion ➔ only for plan with a Roth account provision
  - i.e. 401(k), 403(b), 457(b) governmental plans
  - May not have Roth provision only for conversions
  - IRRs not allowed in plans that may not have Roth
    - E.g. profit sharing, money purchase

- IRR Effective upon enactment ➔ Sept. 27, 2010
- Available for participants or surviving spouses
SBJA IRR Requires Distributable Event

• Between 2010 and 2012, IRR requires a distributable event
  — 2010 conversions only: Tax in 2010; or half in 2011, half in 2012

• Any distributable event that is eligible for rollover is valid

• Withdrawal restrictions apply
  — In-service not available until after age 59½ for:
    • elective deferrals, safe harbor 401(k) contributions, QNECs, QMACs
  — In-service for employer NEC or match
    — 2-year rule (Contribution must be in plan for 2 years)
    — 5-year of participation rule

• New plan provision to limit an in-service withdrawal for only Roth conversions
  — In joint committee report, and IRS Notice 2010-84

IRRs Not Treated as a Distribution for the Following

1. **Plan loan** transferred to Roth account (without changing its repayment schedule) is not a new loan;

2. **Spousal consent is not required** to make an IRR;

3. **IRRs counted as part of Vested Account Balance** when determining if participant’s VAB exceeds $5,000;

4. **Optional forms of benefit may not be eliminated.**
   — Participant’s distribution right prior to IRR cannot be eliminated after electing an IRR. (Q/A-3)
Tax Consequences

Recapture Tax

• For IRs: Under age 59½, 10% penalty waived

• RECAPTURE TAX ➔ The 10% will be applied if the IRR conversion is withdrawn before 5 years

• Recapture tax will not apply if:
  – Attainment of age 59½
  – Distribution due to severance from service in year age 55 attained or later,
  – A known exception to the penalty occurs

Undoing Roth Conversion

Recharacterization

• Roth IRA conversion ➔ reversed by a “recharacterization”

• Recharacterization ➔ individual changes converted Roth IRA (with earnings) back to a traditional IRA
  – amount recharacterized remains tax deferred

• Recharacterization Deadline
  – Taxpayers have until the due date of federal income tax return (including extensions) for year Roth IRA conversion

• A conversion from 401(k) to a Roth IRA may NOT be recharacterized back to a 401(k) plan
  – It may be recharacterized to a traditional IRA
Recharacterization Example

- Feb. 2008: John converts $250,000 traditional IRA ➔ to Roth IRA.
  - By Feb. 2009, account balance has dropped to $150,000.

- If John takes no further action, he would have to include the $250,000 conversion amount as income for the 2008 tax year, even though it is now worth only $150,000.

- If John recharacterizes his Roth IRA back into a traditional IRA, the conversion and recharacterization will have no tax consequences for the 2008 tax year.

- John may again convert this money into a Roth IRA at a later time.

“Recharacterization” NOT Permitted for IRR

- A conversion from a traditional IRA to a Roth IRA may be recharacterized prior to the individual’s tax filing deadline, including extensions.

- There are no recharacterizations of IRRs (within plan conversions) back to pretax qualified plan sources.
Other Considerations

• **Individual must have ability to pay tax on amount converted**
  – Withdrawing additional amount above conversion and having 100% withholding
    • Requires distributable event
    • If under 59½, distribution above conversion is subject to 10% penalty

• **Disclosures**
  – Disclosure to participant in SMM of plan amendment
  – Of taxes due upon conversion, 402(f) Notice

Series of Conversions

• An individual may convert a small amount each year instead of converting all at once
  – This enables an individual to spread taxation out
  – Multiple conversion tracking for 5 year recapture tax
  – Required for Form 1099-R, Box 10 is for reporting IRRs withdrawn before 5 years have passed
    • From the Form 1099-R instructions for reporting distributions of in-plan conversions before 5 years have elapsed
Measuring Five-taxable-year Recapture Period

• **Recapture tax’s 5-taxable-year period**
  – starts with the first day of participant’s tax year in which in-plan Roth conversion made, usually Jan 1.
  – ends on last day of individual’s 5th taxable year after conversion.
  – Amounts may be rolled to another Roth without penalty. If withdrawn from subsequent Roth before end of 5-year period, 10% recapture tax will apply.

• A separate designated Roth sub-account should be established for each in-plan Roth conversion in order to appropriately apply the recapture tax or acceleration of income rules.

Plan Amendment

• Plan must have Roth provision to permit IRRs
  – Notice 2010-84 Q/A-20: To have a qualified Roth contribution program in place means to have deferral elections permitting Roth deferrals available at the point when the IRR is to be implemented.

• **DOCUMENT AMENDMENTS**
  – SBJA ➔ snap-on to EGTRRA document, built into PPA document
  – ATRA ➔ snap-on amendment to the EGTRRA & PPA document
Notice 2013-74
IRR Rules for ATRA and SBJA

2013 In-plan Roth Transfers:
No Distributable Event Required

• As of January 1, 2013, a distributable event is not required to make an IRR

• ATRA added an IRR via a “transfer” option in addition to the IRR option from the Small Business Jobs Act of 2010.
N. 2013-74, ATRA & SBJA IRR Rules

• Otherwise **Nondistributable Amounts** (ONA)
  – Sources/Amounts not eligible to be distributed but that may be converted by an in-plan Roth rollover (aka Transfer)
  – ATRA Section 903 used this term

• Otherwise **Distributable Amounts** (ODA)
  – Sources/Amounts eligible for distribution that could be converted under in-plan Roth Rollover guidance from SBJA 2010

Otherwise Nondistributable Amounts

• Otherwise **Nondistributable Amounts** (ONAs)
  – Elective deferrals prior to age 59½, plus earnings
  – Matching contributions, plus earnings
  – Safe harbor 401(k) contributions prior to 59½, plus earnings
  – QNECs, QMACs, plus earnings
  – Annual deferrals in Gov’t. 457(b), including the federal government’s Thrift Savings Plan
  – Money purchase plan accounts that were transferred into a 401(k) plan
ATRA IRR Rules for ONAs: Plan Options

• A plan may restrict:
  – the type of contributions eligible for IRR
  – the frequency of IRRs

• Subject to 401(a)(4) Benefits, Rights & Features Testing

• A plan design could provide that only Otherwise Distributable Amounts are eligible for IRR (i.e. use only the SBJA IRR rules under N. 2010-84)

Notice 2013-74: Other Rules

• IRR = not a protected benefit

• IRR = taxable event triggering net unrealized appreciation

• IRR = related rollover for top heavy purposes
Designated Roth and Roth IRA

Should Individual Make a Roth Deferral or a Roth IRA Contribution?

- Designated Roth may receive match

- No income limitations for eligibility to contribute to designated Roth (Roth IRA has income limitations)
  - Therefore, higher income employees will be able to contribute to Roth 401(k)
Pro-Rata Distributions, Not Ordering

• Roth 401(k), 403(b) and gov’t. 457(b) do not have the same distribution ordering rules as a Roth IRA

• Roth IRA: you can take after-tax contributions out first and leave the earnings

• Designated Roth plans: you must withdraw pro-rata (Roth and earnings) of non-qualified distributions

Roth IRA “Ordering Rules”

• Roth IRAs have an ordering of which sources are to be distributed first (instead of pro-rata)
  – Note: All Roth IRAs are aggregated for these rules (Roth and traditional IRAs are not aggregated)

• First: Roth IRA contributions OR rollovers from designated Roth accounts
• Second: Converted funds
  – FIFO: Funds that were taxable
  – FIFO: Funds not taxable such as non-deductible IRA
• Third: Earnings
Roth IRA Distribution
Ordering Rules - Example

• In 2015, Roth IRA: $15,000 cumulative amount of
Roth IRA contributions, excluding earnings

• In addition, there is $40,000 of conversion from a
traditional IRA in 2013

• In 2015, individual (age 35) withdraws $16,000
  – The first $15,000 is from Roth IRA contributions
  – $1,000 is from the conversion amount
  – The $1,000 is subject to the 10% penalty, due to
    withdrawal being made before 5 years of conversion

<table>
<thead>
<tr>
<th>TOP TEN DIFFERENCES BETWEEN A ROTH IRA AND A DESIGNATED ROTH ACCOUNT</th>
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<tbody>
<tr>
<td><strong>Roth IRA</strong></td>
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<tr>
<td>Number of Investment Choices</td>
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<tr>
<td>Participation</td>
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<td>Contribution limits</td>
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<td>Recharacterization of rolled-over amounts</td>
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<td>Required minimum distributions</td>
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<td>Tax on nonqualified distributions</td>
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<td>Withdrawals</td>
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<td>Loans</td>
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<td>5-year holding period for qualified distributions</td>
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<td>Beneficiary</td>
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Roth IRA Cannot Be Rolled to a 401(k) Roth

• Why?
  – Law prohibits, there is no conduit Roth IRA

• Measuring five-year period differences
  – Roth IRA v. Roth 401(k) different clocks
    • Roth IRA, from first Roth IRA
    • Roth 401(k)

• Ordering Rules for Roth IRA v. Pro-rata rules for Roth 401(k)

Roth IRA Conversion Advantages Vs. In-plan

• Conversion to Roth IRA Advantages
  – Traditional IRA to Roth IRA may be recharacterized
  – Roth IRA has no RMD during participant lifetime; beneficiaries subject to RMDs
  – No distributable event required to access
  – Roth IRA cannot be rolled back into 401(k)
  – Possibly less fees

• IRR In-plan Roth rollover conversion advantages
  – Creditor protection
  – Spousal beneficiary protection
  – Possibly less fees
  – Possible loan
  – Fiduciary provides prudent investments
After-tax Contributions and IRRs and Roth Rollovers After Notice 2014-54

After-tax and Rollovers Notice 2014-54

• Multiple destination rollovers, e.g. rollovers to 401(k), IRA and 60-day participant rollover made at the same time when participant has pre-tax and after-tax amounts involved.
After-tax and Rollovers
Notice 2014-54

• To determine the after-tax portion of distribution, treat all disbursements scheduled at the same time as a one distribution, regardless of whether distributions are paid to one or more destinations (payees).

• Contained Proposed Roth Regulation
  – To change designated Roth rollover distribution regulations so that a participant or a direct rollover are not treated as separate distributions.

Roth Distribution Example

• Participant age 40 has $10,000 401(k) balance
  $9,400 of designated Roth and $600 earnings

• The participant scheduled two distributions at the same time
  – $5,000 to roll to Roth IRA, and
  – $5,000 to be paid to himself
Roth Distribution Example

- Notice 2014-54, pretax first by direct rollover,
  - The $600 of earnings would be included in the $5,000 directly rolled to the Roth IRA
  - The $5,000 paid to the participant would be all Roth and not subject to taxation

After-tax and IRRs

- After-tax may be permitted to be an in-service distribution conversion to 401(k) Roth (IRR)
- Benefits: within limitations, permits participant to maximize the Roth 401(k) contributions
- Caveats:
  - 415 limitation cannot be exceeded.
  - After-tax amounts are part of ACP test
    - Even a SH matching plan must run an ACP test for the after-tax
After-tax and IRRs

- If there are earnings on the after-tax being converted via an IRR, the options are to:
  - Include the earnings in the IRR and pay tax on the earnings
  - Roll the after-tax to a Roth IRA and the earnings to a traditional IRA

After-tax and IRRs Vs. Roll to Roth IRA

- Rolling to a Roth IRA has advantages:
  - Ordering rules for Roth IRA distributions
  - One Roth IRA 5-year clock for the lifetime of the taxpayer, if already started a Roth IRA, then new money picks up the existing clock
  - No RMDs on Roth IRA, while IRA owner alive
  - For a solo-k, rolling after-tax to a Roth IRA may help keep the balance below the $250,000 threshold for Form 5500-EZ
  - Recharacterization to a traditional IRA
Handling Plan Sponsor or Participant FAQs

FAQs

• What are some areas of confusion?

• The Five Year Clocks
  – 5-year clock for recapture tax
  – Tax-free 5-year clock
  – Difference between recapture 5-year clock and tax-free 5-year clock
  – Roth IRA separate 5-year clock from designated Roth
Plan Sponsor FAQs

• Plan Design and Conversions
  – Conversion of entire amount in one year or multiple conversions over time
  – SBJA IRR or ATRA IRR or both?
    • Need for a distributable event in order to make a in-plan Roth rollover or conversion to a Roth IRA
    • ATRA’s no distributable event for an IRR

• Plan Design and Conversions
  – Frequency of permitting an IRR conversion?
    • Annual, quarterly, other?
  – Limitation of any sources for conversion?
    • Other than deciding on ONA or ODA
    • Will Money Purchase Source be permitted?
    • After-tax conversions via in-service distribution
  – Adding an in-service provision solely for IRRs
Roth Conversions
Participant FAQs

– If conversion is for you, what type?
  – IRR, or
  – Roth IRA, or
  – Rollover to traditional IRA and convert to Roth IRA, now or later, or
  – A series of conversions

– Understanding the recapture tax
– Understanding recharacterization
– Paying tax now versus later?
  • Software programs exists
  • CPA for tax advice

Roth Conversions
Participant Considerations

• Whether conversion is right for an individual depends on a number of factors
  – Tax free earnings
  – Whether tax rates lower now then when distribution made
  – Estate tax planning, with Roth IRA there are no RMDs, leaving entire amount to beneficiaries
  – Do you need withdrawals within next 5 years?
  – Where is $ coming from to pay taxes on the conversion amount?
Roth Conversions
Participant Considerations

• Whether conversion is right for an individual depends on a number of factors
  – Do you currently maintain IRAs or Roth IRAs?
  – Time horizon until retirement will enable regeneration of funds used to pay taxes
  – Is re-characterization a possibility, if so, then consider carefully before tax filing deadline
  – Qualified Roth distributions are not included in income for purposes of determining whether Social Security benefits are taxable
  – Is after-tax to be maximized in 401(k) and then moved by IRR?
    • Beware 415 limitation
    • Beware ACP test

Questions & Comments

• Thank you for attending!!

• E-mail any questions or comments to me at: WCGrossman@dstrs.com
For Reference
Roth Form 1099-R Reporting

<table>
<thead>
<tr>
<th>PAYER'S name, street address, city or town, state or province, country, and ZIP or foreign postal code</th>
<th>1 Gross distribution</th>
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<td>2a Taxable amount</td>
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<td>2b Taxable amount (if determined)</td>
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<td>PAYER’S federal identification number</td>
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<td>3 Capital gain included in box 2a</td>
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<td>4 Federal income tax withheld</td>
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<td>5 Employee contributions</td>
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<td>6 Net unrealized appreciation in employer’s securities</td>
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<td>Recipient’s name</td>
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<td>7 Distribution codes</td>
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<td>8 Other</td>
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<td>9a Your percentage of total distributions</td>
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<td>9b Total employee contributions</td>
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<tr>
<td>10 Amount allocable to IRA within 5 years</td>
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<td>Account number (see instructions)</td>
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<td>17 Local distribution</td>
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Designated Roth & Form 1099-R

• A separate Form 1099-R must be issued for designated Roth account distributions.

• Code B is for all Roth distributions. (Qualified distributions and distributions which have not yet become qualified).

• Box 11 is for reporting the first year of the designated Roth account.

• Box 10 is for reporting the distribution of an In-plan Roth Rollover (IRR) that has been distributed before 5 years after the conversion.

Designated ROTH Distribution

Severance and Partial Distribution

• Participant, age 40, has $10,000 balance
  – $9,400 of designated Roth contributions
  – $600 of earnings

• Participant withdraws $5,000
  – $4,700 is Roth; $300 earnings

• Form 1099-R
  – Box 1  $5,000
  – Box 2a $300
  – Box 4  $60  (20% mandatory withholding)
  – Box 5  $4,700 (Roth basis)
  – Box 7  Code B
  – Box 11 First year of 5-year clock.
Designated ROTH Distribution
Severance & Direct Rollover to Roth IRA

• 8 Months Later participant has $5,000 balance remaining
  – $4,700 of designated Roth contributions
  – $300 of earnings
• Participant directly rolls $5,000 to Roth IRA
  – $4,700 is Roth; $300 earnings
• Form 1099-R
  – Box 1 $5,000
  – Box 2a $0
  – Box 4 $0
  – Box 5 $4,700 (Roth basis)
  – Box 7 Code H
  – Box 11 First year of 5-year clock.

Severance &
Direct Rollover to Roth IRA

• If this participant scheduled both distributions at the same time
• Starting with $10,000 Roth of which $600 was earnings and requested $5,000 to roll to Roth IRA and $5,000 to be paid to himself
• Notice 2014-54, pretax first by direct rollover, So the $600 earnings would go to the Roth IRA;
• Form 1099-R for direct rollover
  – Box 1 $5,000
  – Box 2a $0
  – Box 4 $0
  – Box 5 $4,400 (Roth basis)
  – Box 7 Code H
  – Box 11 First year of 5-year clock.
• Form 1099-R for distribution to Participant
  – Box 1 $5,000;  Box 2a $0;  Box 5 $5,000;  Box 7 Code B
QP Non-ROTH Distribution in 2015; Sever & Direct Roll to Roth IRA

- Participant has $120,000 balance
  - $108,000 of ER, EE non-Roth contributions. Plus earnings
  - $12,000 of after-tax
- Participant directly rolls $120,000 to Roth IRA
- Form 1099-R
  - Box 1 $120,000
  - Box 2a $108,000
  - Box 4 $0
  - Box 5 $12,000 (after-tax basis)
  - Box 7 Code G

QP Non-ROTH DISTRIBUTION in 2015 Direct Rollover to Traditional IRA

- JP Participant has $200,000 balance
  - $190,000 of ER, EE non-Roth deferrals + earnings
  - $10,000 of after-tax
- JP Participant directly rolls $200,000 to Traditional IRA
- Form 1099-R
  - Box 1 $200,000
  - Box 2a $0
  - Box 4 $0
  - Box 5 $10,000 (after-tax basis)
  - Box 7 Code G
- Form 5498, Traditional IRA
  - Box 2: $190,000
  - No taxation on entire amount
QP Non-ROTH Distribution in 2015 Direct Rollover to Traditional IRA

- JP Participant: $200,000 balance; arranges total distribution
  - $190,000 of ER, EE non-Roth deferrals + earnings
  - $10,000 of after-tax
- JP Participant directly rolls $190,000 to Traditional IRA
- Form 1099-R
  - Box 1 $190,000
  - Box 2a $0
  - Box 4 $0
  - Box 7 Code G
- Form 5498, Traditional IRA
  - Box 2: $190,000, No taxation on entire amount
- Form 1099-R
  - Box 1 $10,000
  - Box 2a $0
  - Box 5 $10,000
- Per Notice 2014-54

QP In-plan ROTH Rollover in 2015 aka In-plan Roth Conversion

- Participant M: $75,000 balance; over age 59½; in-service distribution; all pre-tax sources: $75,000 of ER matching and EE pre-tax elective deferrals. Plus earnings
- Participant M makes an in-plan Roth Rollover to a designated Roth account of all $75,000
- Form 1099-R
  - Box 1 $75,000
  - Box 2a $75,000
  - Box 4 $0
  - Box 5 $0
  - Box 7 Code G
- 2015 Form 8606, Participant Files with Form 1040
  - Part III: Report in-plan Roth Rollover
QP In-plan ROTH Rollover in 2015 aka In-plan Roth Conversion

- Participant M: $150,000 balance; age 40; in-service distribution for purpose of in-plan Roth rollover under ATRA; pre-tax sources: $145,000 of ER matching, safe harbor QNEC, EE pre-tax elective deferrals; $5,000 after-tax and earnings
- Participant M makes an in-plan Roth Rollover to a designated Roth account of all $150,000
- Form 1099-R
  - Box 1 $150,000
  - Box 2a $145,000
  - Box 4 $0
  - Box 5 $5,000
  - Box 7 Code G
- 2014 Form 8606, Participant Files with Form 1040
  - Part III: Report in-plan Roth Rollover

QP Designated ROTH Direct Rollover to Roth IRA 2015

- JP Participant has $50,000 of 401(k) Roth balance
  - $46,000 Roth contributions.
  - $4,000 earnings
- JP Participant directly rolls $50,000 to ROTH IRA
- Form 1099-R
  - Box 1 $50,000
  - Box 2a $0
  - Box 4 $0
  - Box 5 $46,000 (after-tax basis)
  - Box 7 Code H
  - 1st year of Roth 2008
- Form 5498, Roth IRA
  - Box 2: $50,000
  - No taxation on $4,000