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"Plan sponsors may find those considerable efforts worthwhile because the in-plan Roth conversion option may be valuable for employees who desire for a greater portion of their 401(k) plan balance to grow on an after-tax basis."

IN-PLAN ROTH CONVERSIONS

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On September 27, 2010, President Obama signed into law the "Small Business Jobs Act of 2010" (the "Act"), which includes a special provision allowing 401(k) plan participants[1] to convert pre-tax amounts to after-tax Roth accounts. This special provision is particularly noteworthy for two reasons. First, it permits participants to accomplish the conversion without rolling the monies out of the plan and into a Roth IRA. In other words, the amounts need not leave the plan for their status to change from pre- to after-tax. Second, participants who effectuate the conversion in 2010 receive the option to equally split the resulting recognized income between 2011 and 2012. This ability is not available in future years.

The special ability to further defer the recognition of income for conversions occurring in 2010 creates some urgency for plan sponsors. There is less than three months' time in which to take most, if not all, of the steps necessary to allow participants to receive the particularly favorable tax treatment of spreading gross income between two future taxable years. For example, plan sponsors will need to evaluate the degree to which current plan provisions permit distributions eligible for the conversion, determine whether to permit the in-plan conversions and whether to make any changes to expand their availability, communicate with participants, receive participant elections, and, perhaps, adopt any necessary plan amendments. Plan sponsors may find those considerable efforts worthwhile because the in-plan Roth conversion option may be valuable for employees who desire for a greater portion of their 401(k) plan balance to grow on an after-tax basis. This brief newsletter is intended to assist plan sponsors with those efforts.

Roth Conversions, Prior to the Act

The Pension Protection Act of 2006 permits 401(k) plan participants to convert pre-tax amounts to a Roth account only by directly rolling over the pre-tax amounts from the 401(k) plan to a Roth IRA. Those pre-tax amounts are included in the participant's taxable income for the year in which the distribution from the 401(k) plan occurs. Mandatory withholding does not apply to the distribution if directly rolled over to the Roth IRA, but the participant may elect for voluntary withholding to apply. This, in essence, allows a participant to pay all or a portion of the tax associated with the conversion from plan assets.

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[1] The in-plan Roth conversion option is also available to surviving spouses, but this newsletter will refer only to participants. Also, the Act makes the conversion option similarly available to 403(b) plans and permits Roth accounts in governmental 457(b) plans for the first time in 2011, but his newsletter will generally refer only to 401(k) plans.

In-Plan Conversions Under the Act

The Act permits those pre-tax amounts to be converted into the 401(k) plan's designated Roth account, without the need for a rollover. There are three important limitations on the availability of the conversion. First, the distribution must occur after September 27, 2010. Second, the distribution must be an "eligible rollover distribution" available because of an event triggering an eligible rollover distribution. That is, absent such a triggering event (described in detail within the checklist below), a participant may not simply submit an election to convert pre-tax amounts. Third, the 401(k) plan must otherwise include a qualified Roth contribution program. In other words, a plan may not permit in-plan Roth conversions without also generally permitting participants to make Roth contributions.

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Tax Consequences

The in-plan Roth conversion option is available for late 2010 and future years, but the ability to further defer the income created by the conversion is available only for conversions occurring in 2010. In general, an in-plan Roth conversion will result in the participant being taxed on the pre-tax amount converted in the year the conversion occurs. As noted above, however, a special rule applicable in 2010 allows a participant to elect either for that general rule to apply (and be taxed in 2010) or to be taxed on half of the taxable amount of the rollover in 2011 and the other half in 2012. The IRS has informally indicated on its website that a participant electing to include the entire amount in his or her 2010 gross income may not revoke that election after the due date, including extensions, of his or her 2010 federal income tax return.

We are hopeful for additional guidance from the IRS regarding any withholding requirements triggered by an in-plan Roth conversion. In the context of direct rollovers from a 401(k) plan to a Roth IRA, the IRS has explained that mandatory withholding does not apply but that participants may enter into a voluntary withholding agreement. It is not clear whether that same rationale would apply to in-plan Roth conversions, particularly because there would not otherwise be an amount leaving the 401(k) plan from which voluntary withholding could occur. Importantly, this means it is presently unclear whether participants will be able to pay all or a portion of the tax associated with the conversion from plan assets, or whether participants must access some other source to satisfy the resulting tax liability.

Checklist for Employers

There are several steps for employers to take in relation to the new in-plan Roth conversion option. The following checklist aims to help employers with those steps:

1. *Does the plan permit Roth contributions?* As described above, this is a prerequisite for permitting in-plan Roth conversions; designated Roth accounts may not be established solely for the purpose of the conversions. The legislative history does not suggest that the qualified Roth contribution program must have been in place for at least a prescribed amount of time before the in-plan conversions become permissible. Thus, we assume (although we cannot yet be certain) that a plan sponsor that does not presently permit Roth contributions from compensation may begin to do so and offer the in-plan Roth conversion option.

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2. *What distributable events are permissible under our plan and would be eligible for in-plan Roth conversions, and should we expand the plan's list of distributable events in order to make the in-plan conversion option more widely available to participants?* Consider a 401(k) plan that allows Roth contributions and does not permit distribution of any type of contribution until the participant severs employment. An in-plan Roth conversion would effectively be available only for former employees. That is because, as noted above, there must be an event triggering an eligible rollover distribution before the in-plan Roth conversion may occur. The Tax Code and various forms of IRS guidance permit various triggering events, depending on the type of contribution.

   Pre-tax deferrals, safe harbor contributions, QNECs, and QMACs may not be distributed earlier than: (i) severance from employment, death, or disability; (ii) plan termination; (iii) attainment of age 59 1/2; or (iv) in the case of a qualified reservist distribution, the date of the order or call to active duty for a period in excess of 179 days or for an indefinite period. Profit-sharing contributions, nonelective contributions that are neither safe harbor contributions nor QNECs, and matching contributions that are neither safe harbor contributions nor QMACs may be distributed after: (a) a fixed number of years, but not less than two; (b) the attainment of a stated age; or (c) the occurrence of some event, such as having participated in the plan for at least five years, layoff, illness, disability, retirement, death, or severance of employment. Rollover amounts reflected in a separate account may be distributed at any time upon the participant's request.

   Thus, to make the in-plan conversion option more widely available, some plans may have to be changed to allow distribution upon some or all of the triggering events listed above. Some plan sponsors may not be eager to expand their 401(k) plan's distributable event options and to broadly open up their plans to allowing monies to prematurely leave the plan. The Act's legislative history anticipates this reluctance, however, by permitting (but not requiring) a plan sponsor that expands its distribution options to condition eligibility for a new distribution option on an employee's election to have the distribution directly rolled over to the designated Roth program within that plan.

   For example, a 401(k) plan could be modified to permit an in-service distribution of profit-sharing and other non-safe harbor/non-qualified nonelective or matching contributions upon a participant having participated for five years or attaining a specific age, and to permit distributions of pre-tax deferrals and any safe harbor contributions at age 59 1/2. The plan could condition the availability of any of those new options upon the participant's election of an in-plan Roth conversion of the entire amount distributed pursuant to the election.

3. *What steps should we take to communicate with participants?* Plan sponsors that wish to make in-plan Roth contributions available will have a strong interest in describing the in-plan conversion process to plan participants as soon as possible. (It is unclear whether this would simply be a good communicative step or whether there might be some fiduciary duty to make the disclosure.) Those communications will likely describe the distributable events and types of contributions eligible for conversion, and the process and timeline for electing a distribution. They also will likely include modified plan distribution paperwork.

4. *Do we need to amend our plan?* The Act's legislative history proclaims that a plan must be amended in order to allow the in-plan Roth conversions. The less certain issues are how soon any amendment must

be adopted and, if a plan sponsor delays the adoption of an amendment, what kind of changes will an expected remedial amendment period permit to be made on a retroactive basis? Technically, and until we receive additional guidance from the IRS, any plan changes must be reflected in a plan amendment adopted prior to the end of the plan year in which the changes become effective. The Act's legislative history expresses the intention that the IRS provide a remedial amendment period, however, that will allow additional time to amend plans. Although we are hopeful for that additional time, some plan sponsors may find it prudent to proceed with amendments prior to the end of the current plan year because: (i) the need to communicate with participants will have already necessitated final decisions regarding what, if any, plan changes will be necessary; (ii) the plan amendment is the cleanest place to memorialize those decisions; and (iii) it is unknown how broadly the remedial amendment period will apply (that is, to what extent it will permit not only the retroactively effective addition of the in-plan conversion option for previously available distribution options, but also the retroactive addition of, for example, a qualified Roth contribution program or additional distributable events).

Closing

Participants who desire to have a greater percentage of their 401(k) plan balances growing in an after-tax Roth account may wish to take advantage of the new in-plan Roth conversion option, particularly if they can accomplish the conversion late in 2010 and be able to defer the recognition of gross income into the following two years. In most cases, a plan sponsor will need to evaluate its 401(k) plan's current provisions to determine the degree to which the current distribution options would present the in-plan conversion option and consider whether to add additional distributable events in order to make the option more widely available. That may be the easy part; the greater challenge lies in the administrative details – to timely communicate with employees regarding the special treatment available in 2010, make any corollary changes to election paperwork, ensure that all withholding and reporting obligations are satisfied, and, possibly, amending the plan. If you have additional questions regarding the new law, possible changes to your plan, or the administrative steps described above, please do not hesitate to contact us.

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