Roth In-Plan Conversion Q&A

For Plan Sponsors

The following questions and answers are intended to provide a high level overview of Roth in-plan conversions and some points to consider. We encourage you to speak with your legal counsel or adviser before deciding to allow these conversions.

Background

The Small Business Jobs and Credit Act of 2010 was signed into law September 27, 2010. The law contains provisions that permit conversion of otherwise distributable 401(k), 403(b) and governmental 457(b) plan account balances to a Roth account in the plan in lieu of having to transfer pre-tax monies to a Roth IRA in order to complete a conversion. **These conversions are considered Roth in-plan rollovers.**

The American Taxpayer Relief Act of 2012, which was passed on January 1, 2013, lifted the restrictions on converting 401(k), 403(b) and governmental 457(b) plan accounts to a Roth account. This allows employees who are not eligible for a distribution to convert their accounts to a Roth designated account in their plan at any time. **These conversions are considered Roth in-plan transfers.**

Q: Must the plan allow Roth in-plan rollover and/or Roth in-plan transfer provisions?

A: No. These are optional provisions. If you would like to add Roth in-plan conversion provisions to your plan, we recommend that you adopt amendments for Roth in-plan rollovers and Roth in-plan transfers. You may limit Roth in-plan conversions to only those eligible for a distribution (i.e., Roth in-plan rollovers); however, you may not limit Roth in-plan conversions to only those employees not eligible for a distribution (i.e., Roth in-plan transfers).

Q: What requirements must a plan satisfy to allow Roth in-plan rollovers and/or Roth in-plan transfers?

A: To allow for a Roth in-plan rollover and/or Roth in-plan transfer:

- The plan must allow employees to make designated Roth contributions.
- The plan must be amended to include Roth in-plan rollover and/or Roth in-plan transfer language. These are separate amendments.

Q: Who is eligible to request a Roth in-plan rollover?

A: If your plan provides, an employee eligible to take a distribution or a surviving spouse can convert their account balance to a Roth designated account via an in-plan rollover.

Q: Who is eligible to request a Roth in-plan transfer?

A: If your plan provides, an employee who is not eligible for a distribution may convert their account balance to a Roth designated account via an in-plan transfer.

Q: What money types can be converted to Roth?

A: Generally, the following pre-tax monies can be converted:

- Elective deferrals
- Employer non-elective contributions that are 100 percent vested
- Employer matching contributions that are 100 percent vested
- Rollovers

Q: Are there any pre-tax monies that cannot be converted to Roth?

A: Pre-tax monies that are not eligible for rollover cannot be converted. Examples include:

- Non-vested employer contributions
- Required minimum distributions (RMDs)
- Hardship distributions
- Any of a series of substantially equal periodic distributions paid at least once a year over:
  - The employee's lifetime or life expectancy
  - The employee and their beneficiary's lifetimes or life expectancies
  - A period of 10 or more years
- Excess contributions, excess deferrals, excess annual additions or other corrective distributions, and any income on these amounts
- A loan treated as a distribution because it didn't satisfy all of the loan requirements under Code section 72(p) at the time the loan was made or later, unless the employee's accrued benefits are reduced (offset) to repay the loan
- Dividends on employer securities
- Cost of life insurance coverage

Q: Why would an employee want to request a Roth in-plan conversion?

A: Qualified Roth distributions, including earnings, are tax- free. An employee who expects to be in a higher tax bracket when they retire can pay taxes on the converted amount now at their current rate and not owe additional taxes on qualified Roth distributions made after they retire.

Q: What should an employee consider before converting their eligible account balance?

A: Employees should consider whether they:

- Are prepared to pay the tax liability attributable to the converted amounts
- Are willing to accept the risk of converted monies being out of the market (un-invested) for one day
- Understand that only fully vested eligible funds are eligible for conversion
- Understand that if they convert less than 100% of a source, funds will be withdrawn from investments on a prorata basis
- Will be able to leave the converted monies in the plan until the qualified Roth distribution requirements are satisfied so they can avoid having to pay the taxes on a distribution of Roth earnings
- Understand that in-plan conversion requests will not change current salary deferral arrangements or investment elections

Further, employees must understand the following:

- Normally there is a 10 percent penalty on distributions made before the employee turns age 59½. This penalty is waived for monies that are converted to Roth. However, there is a recapture tax of 10 percent on any distribution of funds converted via an in-plan conversion that are made before five years have elapsed post-conversion
- Each in-plan conversion requires separate tracking of the five-year period associated with the recapture tax mentioned above even if the employee has already made deferrals in the plan at the time of conversion
- Roth conversion amounts may be included in the calculation to determine the maximum loan amount they may request from the plan, but may not be withdrawn as part of a loan distribution
- Outstanding loan balances cannot be converted to Roth
- While conversions to a Roth IRA can be recharacterized (i.e., revoked) prior to the employee's tax filing deadline, a Roth in-plan conversion is not reversible
- Unless an employee is eligible for a distribution and requests a second distribution for tax withholding that is enough to cover the related tax liability for the Roth in-plan conversion, they may owe estimated taxes on the conversion amount and may incur an underpayment penalty.
- Employees should be encouraged to speak with their financial advisor prior to requesting a Roth in-plan conversion

Q: How does an employee request a Roth in-plan conversion?
A: A specific Roth In-Plan Conversion request form is available upon request from your plan services consultant.

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