



Pension Analyst

Important information

Plan design

October 2010

New law provides additional designated Roth contribution options

Who's affected

This information applies to sponsors of and participants in 401(k) plans, 403(b) plans and governmental section 457(b) plans.

Background and summary

On September 27, 2010, President Obama signed into law the Small Business Jobs Act of 2010 (SBJA). This new law contains two provisions affecting 401(k) plans, 403(b) plans, and governmental section 457(b) plans.

- Effective September 27, 2010, 401(k) and 403(b) plans that accept designated Roth contributions may allow distributable non-Roth account balances to be converted to in-plan Roth accounts.
- Effective January 1, 2011, governmental section 457(b) plans may offer a designated Roth contribution feature. At the same time, these plans will also be able to offer in-plan Roth conversions.

Plans must accept ongoing designated Roth contributions in order to allow in-plan conversions. However, plans that accept designated Roth contributions *are not required to offer* in-plan conversions. Plans that do want to offer such conversions may do so *at any time after the applicable effective date*; they do not have to make them immediately available. Participants in plans that do not offer conversions in 2010, however, will not be able to take advantage of a special rule applicable to conversions occurring in 2010, as discussed further below.

Action and next steps

Since Roth conversions that occur in 2010 are eligible for special tax treatment, plan participants with large pre-tax account balances may be interested in making conversions in 2010. However, it may be difficult to accommodate these requests in the remainder of 2010 since the necessary plan design changes appear to require plan amendments and recordkeeping changes. In addition, the availability of the feature will need to be communicated to all participants in sufficient time to allow them to request a conversion before year-end. Plan sponsors that are interested in making in-plan Roth conversions available should review this publication carefully to become familiar with the rules applicable to this design change and should contact their Prudential Retirement representative with questions. Prudential suggests that plan sponsors promptly discuss any potential plan design changes with their legal counsel.

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Evolution of designated Roth contributions and rollovers

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) authorized the establishment of designated Roth contribution accounts in 401(k) and 403(b) plans beginning January 1, 2006. EGTRRA also allowed participants to roll over distributions of designated Roth contributions to Roth IRAs. Roth contributions are always made on a post-tax basis, so that distributions of these amounts are not taxable. However, the primary attraction of Roth contributions is that earnings on the contributions are also not taxable if they are paid out as part of a qualified distribution.

The Pension Protection Act of 2006 (PPA) allowed participants and beneficiaries to roll over eligible distributions of non-Roth account balances to Roth IRAs beginning January 1, 2008. Participants and spousal beneficiaries were allowed to make direct or indirect ("60-day") rollovers to Roth IRAs, while non-spousal beneficiaries were limited to making direct rollovers to Roth IRAs. Pre-tax amounts (elective deferrals, employer contributions, earnings on contributions) that are rolled over to a Roth IRA are generally included in the participant's or beneficiary's taxable income in the year rolled over.

In response to concerns that the PPA rollover option would cause a leakage of plan assets to IRAs and a loss of certain protections provided to funds held under ERISA plans (for example, the unlimited exclusion of these assets from an individual's bankruptcy estate), the in-plan Roth conversion option is now being made available. In addition, the availability of the designated Roth contribution feature is being expanded to governmental section 457(b) plans.

Designated Roth contributions to governmental section 457(b) plans

Governmental section 457(b) plans are often viewed as the public sector's 401(k) plan, due to their many design similarities. At their core, both types of plans typically accept ongoing pre-tax salary deferral contributions, subject to various contribution limitations. However, EGTRRA only made designated Roth contributions available to 401(k) plans and 403(b) plans. SBJA now returns governmental section 457(b) plans to more equal footing with 401(k) plans by allowing them to accept designated Roth contributions beginning January 1, 2011.

While there are not yet any regulations governing Roth contributions to 457(b) plans, the expectation is that the existing 401(k) and 403(b) rules will be extended to cover 457(b) plans. If that is true, the following rules would apply:

- The plan must offer pre-tax elective contributions in order to offer designated Roth contributions; the plan cannot offer only the Roth feature.
- Roth contributions and related earnings must be recordkept in a separate account (money source).
- Roth contributions must be fully vested and subject to the same distribution restrictions that apply to pre-tax deferral contributions.
- A single 457(b) deferral limit and catch-up limit apply to the combined total of an employee's Roth 457(b) contributions and regular pre-tax contributions.
- Roth 457(b) contributions are subject to the required minimum distribution rules in the same manner as pre-tax elective deferral contributions.
- If the plan uses automatic enrollment, it must clearly specify whether the default contributions will be pre-tax elective deferral contributions or designated Roth contributions.

The new law also allows governmental 457(b) plans to offer in-plan Roth conversions beginning January 1, 2011, subject to the same rules that apply to 401(k) and 403(b) plans, which are discussed below.

In-plan Roth conversions

Beginning September 27, 2010, 401(k) and 403(b) plans may allow non-Roth account balances that are otherwise eligible for distribution to be converted to in-plan Roth accounts. In order for an individual to make an in-plan Roth conversion, both the plan and the individual transaction must meet specific requirements.

Plan must accept ongoing designated Roth contributions

The requirement that the plan accept ongoing designated Roth contributions is the reason different effective dates apply to 401(k)/403(b) plans and governmental section 457(b) plans, since 457(b) plans cannot accept designated Roth contributions until January 1, 2011. A plan cannot be amended to provide Roth accounts solely for in-plan conversion purposes.

A distributable event must exist

An in-plan Roth conversion can only be made with funds that are eligible for distribution from the plan. *For example, 401(k) pre-tax deferrals cannot be converted to Roth amounts before a participant reaches age 59½, dies, becomes disabled, or has a severance from employment.*

If a plan imposes stricter distribution restrictions than required by law, it may be amended to allow additional distribution options. It may also limit those distribution options to in-plan conversions. *For example, a plan that only allows profit sharing contributions to be distributed under the 401(k) distribution rules may be amended to allow those contributions to be distributed after a participant completes at least five years of participation, but only if those amounts are converted to Roth amounts.*

Conversion amount must be an eligible rollover distribution

Only eligible rollover distributions may be converted to an in-plan Roth account. Most distributions from a plan to a participant or beneficiary are considered “eligible rollover distributions.” The following are the most common types of distributions that are *not* eligible rollover distributions, and are therefore *not eligible* for in-plan Roth conversions:

- Payments that are part of a series of substantially equally periodic payments made during the participant's lifetime or life expectancy, or over a period of 10 or more years;
- Required minimum distributions (RMDs);
- Hardship distributions;
- Corrective distributions (correcting excess annual additions, excess deferrals, or failed ADP or ACP tests); and
- Deemed distributions of plan loans.

Only an employee or a surviving spouse may make a conversion

Only active employees, former employees, and spousal beneficiaries may make in-plan Roth conversions. A non-spouse beneficiary may not make a Roth conversion.

Conversion amount must be included in the individual's taxable income

Taxable amounts that are rolled over to a Roth IRA are taxable in the year of rollover. The same tax treatment applies to taxable amounts that are converted to in-plan Roth accounts. As a result, the special rule that applies to rollovers to Roth IRAs in 2010, also applies to in-plan Roth conversions occurring in 2010. Under this rule, the taxpayer may include the taxable amounts in income in equal parts in the 2011 and 2012 tax years, rather than being taxed on the entire amount in 2010. Given the uncertainty of 2011 tax rates, many taxpayers are now eager to make either rollovers to Roth IRAs or in-plan Roth conversions in 2010, to take advantage of the flexibility in taxation.

Adding an in-plan Roth conversion feature

Plan sponsors that want to add an in-plan Roth conversion feature will have to:

- Amend their plans to provide for the in-plan conversion;
 - Identify the contribution sources eligible for conversion; and
 - Define conversion criteria (i.e., “distribution” rules). *For example, additional distribution opportunities may be made available for some contribution sources, but only if the funds are used for an in-plan Roth conversion.*
- Revise recordkeeping systems to add a new contribution source, accommodate conversion transactions, and generate appropriate tax-reporting; and
- Communicate the availability of the new feature to all plan participants.

Some of these actions will require close cooperation with plan recordkeepers and payroll vendors. Sponsors that want to make this option available in 2010, so participants and beneficiaries can take advantage of the special tax options, may be challenged by the number and complexity of the changes required in a short timeframe.

Plan amendments

Plan sponsors may offer in-plan Roth conversions but are not required to do so. If a plan sponsor chooses to offer this feature, the sponsor must amend its plan document accordingly. Typically, an amendment to adopt an optional plan feature is considered a discretionary amendment, which the plan sponsor must adopt by the end of the plan year in which it is effective. As a result, a plan sponsor that wants to make Roth conversions available in 2010 (to allow participants and beneficiaries to take advantage of the special tax option) under a plan with a calendar plan year would have to adopt the applicable plan amendment by December 31, 2010. However, a report of the Joint Committee on Taxation indicates that Congress expects the IRS to provide an extended amendment period for these amendments. So far, the IRS has not indicated if an extended amendment period will be provided.

To be safe, a plan sponsor may want to adopt such an amendment as soon as possible. If the plan document is a prototype or volume submitter document that must first be revised by another entity, the plan sponsor may want to consider authorizing the amendment of the plan via a board of directors' (or similar) resolution adopted in 2010 until a formal plan amendment is available for adoption. Plan sponsors should review the administrative provisions of their plan documents to make sure they follow prescribed amendment procedures.

Plan amendments are also required if the plan needs to add basic ongoing designated Roth contributions in order to make in-plan Roth conversions available, or if distribution provisions need to be revised to provide additional distributable events. Again, these would be considered discretionary amendments. At this time, there is no indication that the IRS will provide an extended amendment period for this type of amendment.

When adding new distribution options, especially those that are limits to in-plan conversions, plan sponsors should keep in mind that they are subject to the nondiscriminatory availability rules. As a result, these options must be made available to both highly compensated employees and non-highly compensated employees.

Recordkeeping changes

At this time, it is not clear how the five-year participation rule for determining "qualified distributions" will apply to in-plan Roth conversions. Currently, [in certain situations](#), different five-year clocks may apply to a participant's ongoing Roth contributions and his Roth rollovers. Until the IRS issues guidance about this requirement, plan sponsors may want to establish separate sources to hold conversion funds.

When establishing Roth conversion sources, plan sponsors will also need to decide how these funds will be invested. If a plan allows participants to make different investment elections for different contribution sources and in-plan Roth conversions are coming from different sources, how will those funds be invested in the absence of affirmative election directions? It is expected that many plan sponsors will wish to designate a default investment for these situations, which could be an existing qualified default investment alternative (QDIA). Conversion directions and forms would have to disclose these procedures. Of course, there will be no need for a default investment if participants who request an in-plan conversion also provide investment instructions (e.g., confirmed continued investment among the same plan investment options in which funds were invested prior to conversion).

From the distribution side of a conversion transaction, several changes may be needed, and considerations should be noted, relating to plan administration and recordkeeping.

- The rollover distribution notice will have to be revised to reflect the in-plan conversion option. Since it is not likely that the IRS will update the safe harbor notice in the very near future, plan sponsors and service providers will need to provide their own updates.
- If the plan provides a specific withdrawal hierarchy, the plan sponsor may need to make revisions to that hierarchy for Roth conversions.
- While it is expected that Roth conversions will have to be reported on Form 1099-R, the IRS has not yet provided instructions for coding these transactions.
- Since only eligible rollover distributions may be converted to an in-plan Roth account and the transaction is essentially a direct rollover, it appears that no mandatory (i.e., 20%) federal income tax withholding will be required. There is no guidance regarding state income tax withholding. Plan sponsors and recordkeepers may

need to make changes to their tax reporting systems to accommodate these new transactions. Until specific guidance is provided, Prudential will offer voluntary federal withholding on these transactions.

Participant and beneficiary notification

Unlike the addition of a safe harbor plan design, which requires advance notice to participants about that plan design change, there is currently no requirement to provide participants of advance notice of a plan's addition of a Roth conversion feature. However, to comply with the qualified plan nondiscriminatory availability rules, sponsors of 401(k) plans that add this conversion option will need to notify participants of its availability, as will sponsors of 403(b) plans that offer in-plan Roth conversions of contributions other than elective deferral contributions.

After the fact, sponsors of plans that are subject to ERISA (e.g., 401(k) and 403(b) plans) will need to furnish participants and beneficiaries with either updated summary plan descriptions (SPDs) or summaries of material modifications (SMMs) that describe the in-plan Roth conversion option. The deadline for distributing an SMM is 210 days after the close of the plan year in which the amendment is adopted. Note that the U.S. Department of Labor recently issued new participant disclosure regulations, effective in November 2010, that will require certain disclosures earlier than the deadlines for SPDs and SMMs.

As noted previously, an updated version of the rollover distribution notice, reflecting the in-plan conversion option, will need to be provided at least 30 days before the distribution date, unless the participant or beneficiary waives the 30-day period upon receiving the notice.

Support from Prudential Retirement

As noted above, plan sponsors and service providers currently have little official guidance to guide them in adopting and implementing in-plan Roth conversion provisions. The IRS has been addressing some of the easier open issues via "soft" guidance published on its website, but many questions still remain. We will continue to monitor this guidance and adapt our product offering accordingly. In the interim, Prudential will make available a conversion feature aligned with our processing capabilities, our interpretation of current law, and anticipated IRS guidance. Prudential will also support the adoption of ongoing designated Roth contributions to governmental section 457(b) plans effective January 1, 2011.

If you are interested in making any of these design changes, please contact your Prudential Retirement representative. Both plan sponsors that use our document services and those that do not use those services should contact their Prudential Retirement representative before adopting an in-plan Roth conversion feature, to ensure that we can appropriately administer the design options that they wish to adopt.

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