



# Pension Analyst

Important information

Plan design

December 2010

## IRS provides preliminary guidance on in-plan Roth rollovers

### 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

The [Small Business Jobs Act of 2010 \(SBJA\)](#) contained a provision allowing plans that accept ongoing designated Roth contributions to also permit the conversion of distributable non-Roth account balances to in-plan Roth accounts. This in-plan conversion/rollover feature was made available to 401(k) and 403(b) plans effective September 27, 2010. It becomes available to governmental section 457(b) plans effective January 1, 2011, when these plans will first be eligible to accept ongoing designated Roth contributions.

On November 26, 2010, the IRS published its first formal guidance regarding in-plan Roth rollovers in the form of [Notice 2010-84](#). This Notice contains 20 Q&As that provide guidance regarding:

- Special plan amendment timing rules for 401(k) and 403(b) plans;
- Eligibility to make in-plan Roth rollovers;
- Treatment of these transactions as distributions, including [402\(f\) rollover notice](#) requirements;
- Taxability of, and withholding on, certain in-plan Roth rollovers; and
- Recordkeeping requirements.

While some of this guidance applies specifically to in-plan Roth rollovers made in 2010, which are only available under 401(k) and 403(b) plans, most of the guidance will also apply to in-plan rollovers made after 2010, when they will also be available under governmental section 457(b) plans.

### Action and next steps

Plan sponsors that are interested in making in-plan Roth rollovers available within their plans should review this publication carefully to become familiar with the additional clarification and the special rules governing 2010 processing. In addition to contacting their Prudential Retirement representatives with questions about these provisions, plan sponsors should promptly discuss any potential plan design changes with their legal counsel.

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## Plan amendment rules

### Amendments to 401(k) plans

The in-plan Roth rollover is an optional plan design feature. As a result, the sponsor of a 401(k) plan that wants to offer this provision would normally have to adopt the appropriate plan amendment by the end of the plan year in which it is added to the plan. Recognizing the challenge this timing would present for plan sponsors that want to offer the feature in 2010, Congress noted that it expected the IRS to provide an extended amendment period for these amendments. In Notice 2010-84, the IRS has done just that. In general, sponsors of 401(k) plans now have until the later of (1) the last day of the plan year in which the amendment is effective, or (2) December 31, 2011, to adopt an in-plan Roth rollover amendment that is retroactively effective as of the first day the plan operationally allows these rollovers.

For a safe harbor 401(k) plan, including a Qualified Automatic Contribution Arrangement (QACA), a slightly different extended amendment deadline applies. For these plans, the deadline is the later of (1) December 31, 2011, or (2) the first day of the plan year for which the safe harbor provisions will be effective. *As a result, an existing QACA with a plan year beginning on July 1 may permit in-plan Roth rollovers beginning September 27, 2010, but the plan sponsor does not have to adopt the related amendment until December 31, 2011.*

### Amendments to 403(b) plans

In a situation where a 403(b) plan was established before January 1, 2010, the employer was required to adopt a written 403(b) plan no later than December 31, 2009. If the employer later adopts a pre-approved 403(b) plan, it will have an extended amendment period in which to correct any document defects retroactive to January 1, 2010. A plan established on or after January 1, 2010, will have the same extended amendment period if the employer adopts a written plan by the plan's effective date and later adopts a pre-approved plan. For these plans, the deadline for adopting an amendment reflecting in-plan Roth rollovers is the later of (1) the extended amendment period, or (2) the last day of the first plan year in which the amendment is effective, as long as the amendment is retroactively effective as of the first day the plan operationally allows these rollovers.

### Types of amendments covered by extended deadlines

The extended amendment deadlines discussed above apply to both the basic amendment to permit in-plan Roth rollovers, as well as some related amendments, such as those that:

- Add ongoing designated Roth contributions;
- Allow a designated Roth account to accept rollover contributions; or
- Add a distribution option that is only available for in-plan Roth direct rollovers.

However, the extended amendment deadlines *do not apply* to amendments to add a basic 401(k) cash or deferred arrangement to an existing profit sharing plan to then allow ongoing designated Roth contributions and in-plan Roth rollovers.

## Eligibility to make in-plan Roth rollovers

The primary requirement for eligibility to make in-plan Roth rollovers is that the plan accepts ongoing designated Roth contributions. Notice 2010-84 confirms that at the time an in-plan Roth rollover is made the plan must have a qualified Roth contribution program in place. This requirement is met on a given date only if, with respect to compensation that can be deferred beginning on that date, employees have the ability to make designated Roth contributions.

An in-plan Roth rollover may only be made with funds that are eligible for distribution from the plan. In this guidance, the IRS confirms and clarifies that:

- Any vested amount, other than designated Roth contributions, may be eligible for an in-plan Roth rollover;
- The amount must be available for distribution;
- The amount must also be an eligible rollover distribution; and
- An in-plan Roth rollover may be accomplished by either a direct rollover or by a 60-day ("indirect") rollover where funds are actually distributed to the individual who then rolls them back into the distributing plan.

If a plan's distribution provisions are more restrictive than required by the Internal Revenue Code, this IRS guidance allows plans to be amended to make distributions available only for purposes of making an in-plan Roth direct rollover. *For example, a plan that does not allow in-service distributions of pre-tax deferral contributions may be amended to allow in-plan Roth direct rollovers of these amounts to participants who have reached age 59½.* However, a plan that already allows distributions at age 59½ cannot be amended to restrict these distributions to in-plan Roth direct rollovers because that type of amendment would violate the anticutback rule.

Since in-plan Roth rollover amounts must be eligible rollover distributions, they may only be elected by:

- Participants;
- Spousal beneficiaries;
- Alternate payees under Qualified Domestic Relations Orders (QDROs) who are spouses; and
- QDRO alternate payees who are former spouses.

*It is important to note that once an individual has elected to make an in-plan Roth rollover, he cannot unwind that election as can be done for rollovers to Roth IRAs.*

## Treatment as distributions

As noted above, amounts are eligible for in-plan Roth rollover only if they are both eligible for distribution and are eligible rollover distributions. However these transactions are not always treated as true distributions.

### When an in-plan rollover is not treated as a distribution

In Notice 2010-84, the IRS explains that an in-plan Roth *direct* rollover is not treated as a distribution for the following purposes:

- **Plan loans:** If an outstanding plan loan is part of an in-plan Roth direct rollover and its repayment schedule is not changed, it is not treated as a new loan with respect to the loan refinancing rules and multiple loan rules.
- **Spousal consent:** A married participant who would normally need spousal consent to a distribution election does not need spousal consent to make an in-plan Roth direct rollover.
- **Right to defer distribution:** Since the amounts rolled-over as an in-plan Roth direct rollover do not leave the plan, the plan is not required to provide the participant with the notice of his right to defer distribution.
- **Elimination of optional forms of benefit:** Since in-plan Roth direct rollover amounts do not leave the plan and do not require spousal consent, they retain the optional forms of benefit that were available in their originating sources.

Since an in-plan Roth *indirect* rollover involves an actual distribution, this type of transaction would be considered a true distribution for all purposes. As a result: spousal consent would be required, if applicable; the plan would have to provide the notice of the participant's right to defer distribution; and the subsequent rollover would be made "cleanly" into the plan without concern about protected benefits.

### When standard distribution rules apply

All in-plan Roth rollovers are subject to the section 402(f) rollover notice requirement. In 2009, the IRS published an updated safe harbor 402(f) notice for plan sponsors to use to fulfill these notice rules. In this new guidance, the IRS has provided instructions for revising the safe harbor notice to reflect in-plan Roth rollover options and has provided a new section describing the consequences of making an in-plan Roth rollover.

## Taxability and tax withholding rules

In general, any taxable amounts that are part of an in-plan Roth rollover must be included in the individual's income in the year in which the "distribution" is made. In most cases, the distribution and rollover will occur in the same tax year. However, an indirect rollover could span two tax years, so the year of actual distribution is the year in which taxable amounts are included in income.

### Special treatment for 2010 in-plan rollovers

Distributions made in 2010 that are rolled over as in-plan Roth rollovers are eligible for special tax treatment. These amounts are automatically included in income half in 2011 and half in 2012. However, the individual may elect to include the entire taxable amount in his 2010 income instead. Notice 2010-84 and related guidance clarify that this special election:

- Must be made on Form 8606 by the individual as part of his tax return filing;
- May not be changed after the due date (including extensions) for filing the individual's 2010 tax return;
- Applies to all of the individual's 2010 distributions that are rolled over as in-plan Roth rollovers; and
- Is separate from any election made with respect to Roth IRA rollovers made in 2010.

### General tax consequences of in-plan Roth rollovers

The taxable amount of an in-plan Roth rollover is the fair market value of the distribution reduced by the participant's basis. The IRS guidance clarifies that if the distribution includes employer securities purchased with employee post-tax contributions, the fair market value *includes* any net unrealized appreciation. In addition, the fair market value includes any outstanding loan balance rolled over.

The IRS confirms that in-plan Roth *direct* rollovers *are not subject* to mandatory 20% federal tax withholding. By implication, in-plan Roth *indirect* rollovers *are subject* to mandatory 20% withholding. The notice does not mention voluntary withholding on either direct or indirect rollovers but does note that an underpayment penalty may apply if taxes are not withheld from direct rollover amounts and the individual does not increase his withholding or make estimated tax payments.

### Special rule relating to 10% early distribution tax

In-plan Roth rollovers are not subject to the 10% early distribution tax. However, a special rule applies if any taxable portion of an in-plan Roth rollover is distributed within a five-taxable-year period following the rollover. In that event, the taxable amount of the distribution is subject to the 10% early distribution tax unless one of the standard exceptions applies. The five-year period begins on the first day of the participant's tax year in which the rollover was made. It appears that if an individual makes multiple in-plan rollovers during multiple years, different five-year periods will apply to each rollover amount.

This special rule does not apply to a distribution that is rolled over to another designated Roth account or to a Roth IRA. However, it does travel with such a rollover and applies to any distributions made from that other account or IRA within the five-year period.

### Impact on plan design decisions

Plan sponsors that are considering the addition of an in-plan Roth rollover feature should review this guidance carefully. While it is generally quite helpful, it may also provide some traps for the unwary. If you are interested in making this feature available under your plan, please contact your Prudential Retirement representative. Because Prudential Retirement developed processes to support in-plan Roth rollovers before this guidance was published, some of the flexibility permitted by Notice 2010-84 is not yet supported within our offering. 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 rollover feature, to ensure that we can appropriately administer the design options that they wish to adopt.

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