<u>IN-PLAN ROTH CONVERSIONS</u>, the GOOD, the BAD and the UGLY

Perhaps you think this is OLD news. However, the American Taxpayer Relief Act (ATRA), effective January 1, 2013, taught that old dog a new trick.

Before January 1, 2013, in-plan Roth conversions or transfer (rollover) to a Roth account were available only if the participant was eligible for a distribution from the plan (e.g. if age 59 ½ <u>and</u> if the plan permitted in-service distributions). NOW any current participant can make an in-plan Roth conversion of any amount held for the participant's benefit if the plan is amended to permit both Roth deferrals and in-plan conversions. This conversion might appeal to young participants, individuals who expect their tax rates to increase in the future or to wealthy savers who want to leave a tax-free retirement account to heirs.

That's the GOOD news. But, the decision isn't a no-brainer. There are a lot of issues to consider before jumping-in either as a plan participant or as a plan sponsor.

- Permitting in-plan Roth conversions is strictly a plan sponsor decision. It is not required even if the plan already allows Roth after-tax deferrals.

- The conversion is <u>100% taxable in the year of conversion</u>. Depending upon the participant's personal cash resources, payroll income tax withholding may have to be increased or quarterly estimated tax deposits made to cover the year's tax liability. Conversion is a highly individualized decision for most participants, requiring a professional tax advisor.

- Conversion is designed to accelerate the governments' collection of current income tax revenue (federal, state and local). Compare this to the 2010 limited in-plan conversion that allowed a multiple tax-year period to spread the pain.

- <u>Required plan provisions still awaiting IRS guidance</u>. In-plan Roth conversions as well as current Roth contributions must be permitted under the plan. A plan sponsor can operationally permit participants to accomplish in-plan Roth conversions prior to a formal plan amendment of a 401(k), 403(b) or 457(b) plan. Because the amendment is "voluntary" on the part of the plan sponsor, the deadline is currently the last day of the plan year in which this amendment becomes effective. Obviously, calendar year plans have an advantage at this point.

- There are still thorny technical issues relating to distribution rules. A number of issues were clarified by the Joint Committee on Taxation explaining that converted amounts will remain subject to all distribution and loan restrictions in place prior to the in-plan conversion. "Grandfathered" distribution restrictions include pre-tax elective deferrals to 401(k)s and 403(b)s, QNECs, QMACs, and employer contributions to 403(b)(7) custodial accounts. Thus, the plan administrator or recordkeeper will be required to track one or more new money sources. Other individual plan distribution restrictions may require separate tracking, at least until the IRS works-out all the kinks. It will very likely increase plan administrative expense.

- Other unresolved issues include the following:
  - Can the non-vested portion of an account balance be converted or transferred?
  - Would a Roth conversion available to a non-spouse beneficiary? Or, can it be limited to active participants?
  - Can availability to a surviving spouse or alternate payee be denied as a plan option?
  - What tax reporting is required in the year of conversion? Form 1099-R?
  - What kind of participant disclosure will be required?