

In-Plan Roth Conversions Expanded Under Fiscal Cliff Tax Law

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For high earners who currently receive compensation above \$450,000, but anticipate a reduction in the level of their income in retirement, the increased tax rates of the American Taxpayer Relief Act of 2012 ("ATRA") have enhanced the allure of deferring income. Deferral can either be through a qualified plan or nonqualified deferred compensation arrangement, in the hope that it will be taxed at a lower marginal rate when it is received. However, many others will continue to find that their anticipated post-retirement tax rates are likely to remain the same as during their working years, or even decline, and for this group the appeal of Roth contribution programs will continue.

A Roth 401(k) or 403(b) plan allows an employee to elect to make after-tax Roth contributions in lieu of all or a portion of the pre-tax deferrals the employee is otherwise eligible to make under such a plan. A qualified distribution (generally, a distribution on or after age 59½, death, or disability that also occurs at least five consecutive taxable years after the employee made the Roth contribution) from a designated Roth account in such a plan is tax-free, whereas a nonqualified distribution is includible in gross income in proportion to the participant's earnings and investment in the account. Apart from this potential tax advantage, a participant may have good reason to prefer maintaining after-tax funds in an employer-sponsored plan, as opposed to a Roth IRA since a plan may offer access to cheaper institutional investments and provide superior protection in bankruptcy.

New In-Plan Roth Conversion Opportunity. The Small Business Jobs Act of 2010 amended the Internal Revenue Code to permit 401(k) plans (as well as 403(b) and governmental

457(b) plans) that include a qualified Roth contribution program to allow individuals to roll over amounts from their non-Roth accounts in the plan to the plan's Roth program. These in-plan Roth rollovers were not broadly available, however, because of the IRS's interpretation in Notice 2010-84 that an amount would not be eligible for an in-plan Roth rollover unless it satisfied the rules for distribution under the tax law. For example, in the case of a 401(k) plan participant who did not have a severance from employment, a rollover to the plan's Roth program from the participant's pre-tax elective deferral account was permitted only if the participant attained age 59½, died, became disabled, or received a qualified reservist distribution. This limitation also applied to safe harbor contributions, QNECs, and QMACs.

For transfers after 2012, ATRA eliminates the requirement that a participant must have a distributable event to convert a non-Roth account to a Roth account in the same plan. The new provision states that a plan may allow an individual "to elect to have the plan transfer any amount not otherwise distributable under the plan to a designated Roth account," and further indicates that this transfer will be treated as a distribution contributed in a qualified rollover distribution to the Roth account. Under the new provision, this deemed distribution will not violate Section 401(k)'s restriction on distributions.

Consequences of Roth Conversion. It remains to be seen whether a deemed distribution stemming from a conversion under the new law will be treated as a distribution for other purposes. Under pre-ATRA law, the IRS took the position that an in-plan direct rollover to a Roth account would not be treated as a distribution for

purposes of: (i) treating a plan loan transferred in the rollover as a new loan, (ii) requiring married participants to obtain spousal consent in connection with the rollover, (iii) requiring notice of a participant's right to defer receipt of a distribution, or (iv) eliminating distribution rights held immediately prior to the rollover. Presumably, this stance will continue under the new and broader conversion opportunity.

As under pre-ATRA law, the taxable amount of the new in-plan Roth rollover must be included in a participant's gross income for the year in which the conversion occurred. Unlike the introduction of in-plan Roth conversions in 2010, the effect of a conversion under ATRA may not be spread over multiple years; this was to be expected given that deficit reduction played a significant role in the provision's enactment. The taxable amount is equal to the fair market value of the amount rolled over reduced by any basis the participant may have in such amount. Under prior law, if an outstanding loan was rolled over in an in-plan Roth rollover, the balance of the loan was includible in income, and this consequence will presumably continue to apply to post-ATRA conversions.

The significant tax liability generated means that participants wishing to convert to Roth should have assets outside the plan with which to pay the tax.

Implementation. Plans that wish to allow in-plan Roth conversions must first provide for Roth accounts if they do not do so already. In addition, they must be amended to permit in-plan conversions. However, a plan cannot establish Roth accounts solely to accept rollovers, of the in-plan variety or otherwise; thus, the plan would also

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have to provide for Roth elective deferrals. Assuming that prior guidance continues to apply, the IRS will view these amendments as discretionary

so that the amendment would need to be adopted by the last day of the plan year in which in-plan conversions are to be effective. While the new rule is permissive, there is likely to be strong demand from participants to implement it, particularly since

many plans already have a Roth contribution program. ❖

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