In-Plan Roth Conversions May Require Plan Sponsors to Take Immediate Action

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On September 27, 2010, President Obama signed the Small Business Jobs Act of 2010 (the "Act"). Among other things, the Act permits participants in Section 401(k) or Section 403(b) plans to convert pre-tax amounts into after-tax amounts, commonly called "Roth amounts" inside a plan.

In-Plan Roth Conversions

Historically, individuals with income in excess of certain amounts were not eligible to contribute to a Roth IRA. (Contributions to a Roth IRA are made on an after-tax basis. As a result, when the individual receives a distribution from a Roth IRA, the earnings on the Roth contributions are not subject to income tax.) In 2006, the Internal Revenue Code was amended to permit a participant in a Section 401(k) or a Section 403(b) plan to make Roth contributions into the plan, regardless of the participant's income.

In 2010, the income limit on converting pre-tax amounts to Roth amounts was eliminated. As a result, anyone can now convert a traditional IRA into a Roth IRA. The Code also was amended in 2010 to permit a participant to rollover a distribution of pre-tax amounts from a qualified retirement plan into a Roth IRA.

Under the Act, a participant may now convert pre-tax amounts to after-tax Roth amounts inside the plan (1) if the plan permits a participant to make Roth contributions from the participant's pay and (2) if a participant is otherwise eligible for a distribution from the plan. In other words, an in-plan Roth conversion is only available to active employees who are eligible to receive an in-service withdrawal (i.e., at age 59½) or former employees who have a remaining balance in the plan.

Plan sponsors are not required to offer the in-plan Roth conversion feature. Nevertheless, plan sponsors may decide to add the Roth conversion feature to increase tax planning flexibility for plan participants.

Generally, an in-plan Roth conversion will result in immediate recognition and taxation of the amount converted. For Roth conversions that occur in 2010, however, favorable income inclusion rules apply. The income from a 2010 Roth conversion may be spread out over the participant's 2011 and 2012 tax years. To take advantage of these favorable income inclusion rules, plan sponsors need to act quickly to determine whether to implement in-plan Roth conversions. Absent additional IRS guidance, plan sponsors who wish to implement in-plan Roth conversions in 2010 must amend their Section 401(k) or Section 403(b) plans before December 31, 2010.

Roth Contributions for Government Plans

Prior to the Act, plans maintained by state or local governments pursuant to Section 457(b) of the Code could not provide for Roth contributions. Effective for taxable years beginning after December 31, 2010, Section 457(b) plans sponsored by state and local governments (but not sponsored by non-profits) may permit Roth contributions as well as the in-plan Roth conversions described above.