In-Plan Roth Conversion

In-plan Roth conversion offers the best of both worlds.

NOBLE-DAVIS CONSULTING, INC.

30275 Bainbridge Road
Building B
Solon, OH 44139

Phone: 440-498-8408
Fax: 440-498-9566
E-mail:
contactus@noblepension.com

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In 2006, Congress passed legislation that allows everyone, regardless of their income level, to convert a traditional IRA to a Roth IRA beginning in 2010. This conversion is a taxable event where the amount of the account converted to the Roth IRA will be taxed. Under this law, participants in 401(k) or 403(b) plans can transfer their distributions from their qualified plan directly to a Roth IRA. However, participants could not transfer their accounts directly to a Roth account within the same plan.

Congress realized this could be problematic since it encouraged participants to transfer their accounts out of the qualified plans. So, with the passage of the Small Business Jobs and Credit Act of 2010, participants will be allowed to convert otherwise distributable 401(k) and 403(b) account balances to Roth accounts within the plan instead of requiring the transfer to a Roth IRA outside the plan. This is exciting news as it allows participants to keep their money inside the retirement plan while receiving many of the benefits that a Roth IRA provides.

Planning ahead with in-plan Roth conversions

In-plan Roth conversions are a great step forward to keep account balances in the plan, but they are not available for all participants. There are several restrictions that go along with the conversion. The restrictions are:

- The plan must already have designated Roth accounts and must be accepting or have accepted Roth deferrals
- Elective deferral and safe harbor accounts can only be transferred for those participants who have attained age 59 1/2
- Vested employer contributions that are not subject to elective deferral restrictions can be transferred to a Roth account, regardless of the participant's age if the contributions have aged for two years, or if the employee has been a participant in the plan for at least five years
- The language of the bill refers to "distributions" as opposed to "transfers." While an actual distribution (writing a check for the transaction) would not occur, the participant must be eligible to receive a distribution from the plan in order for the conversion to be legitimate. So, a plan may have to be amended to allow for in-service distributions, although this option can be limited to those who will be converting their accounts to a Roth account within the plan.

There are many steps to take in order to allow the conversion to occur. These include amending the plan to allow Roth deferral contributions, actually processing Roth contributions, amending the plan to allow in-service distributions for the Roth conversion, and finally, amending the plan to allow the in-plan Roth conversions themselves.

If you are interested in taking advantage of this new legislation, please contact your administrator to get the ball rolling.