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In-plan Roth Conversions: Tax Me Now, Pay Me Later

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Topical Outline

- History of Roth IRAs and Roth 401(k)s, 403(b)s and 457(b)s
- Designated Roth Contributions
- In-plan Roth Conversions
- Roth vs. Pre-tax Contributions
- Indications for Roth Conversions

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“Roth” Contributions - History

- Taxpayer Relief Act of 1997:
  - Authorized Roth IRAs (up to $2,000/yr), beginning in 1998, subject to income limits and contribution limit phase-out:
    - $150,000 to $160,000 AGI for joint filers
    - $95,000 to $110,000 AGI for all other filers
  - Allowed “conversion” of traditional IRAs to Roth IRAs, subject to income limit:
    - $100,000 AGI for single or joint filers (only)
    - Tax on 1998 conversions was spread over 4 years
  - Allowed Roth IRA to be “recharacterized” as a traditional IRA as late as due date of tax return

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“Roth” Contributions - History

- Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA):
  - Increased contribution limit for IRAs and Roth IRAs (gradually, to $5,000 by 2008)
  - Added IRA/Roth IRA catch-ups for those 50 or older (initially $500, then $1000 after 2005)
  - Allowed “designated Roth contributions” (DRCs) to 401(k) and 403(b) plans (after 2005)
    - Roth contributions could only be rolled to another designated Roth contribution account or to a Roth IRA

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Roth Contributions - History

- Tax Increase Prevention and Reconciliation Act of 2005:
  - Eliminated the $100,000 AGI limitation for conversions of non-Roth IRAs into Roth IRAs (effective in 2010)
  - Provided for income on 2010 conversions to be spread over next two tax years (i.e., 50% in 2011, 50% in 2012) unless taxpayer elects to report it all in 2010

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Roth Contributions - History

- Pension Protection Act (2006):
  - Allowed non-spouse rollovers to inherited IRAs after 2006
  - Provided for indexed income limitations on contributions to Roth IRAs (after 2006)
  - Allowed direct rollover of non-Roth amounts (in 401, 403(b) or governmental 457(b) plans) to Roth IRAs after 2007 (subject to $100,000 income limitation on conversions prior to 2010), replacing previous "two-step" process of non-taxable rollover followed by taxable conversion

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Roth Contributions - History

- Small Business Jobs and Credit Act of 2010 (Pub. Law. 111-240):
  - Allows “designated Roth contributions” to governmental 457(b) plans, beginning in 2011
  - Allows “in-plan” (taxable) conversion of non-Roth amounts to Roth amounts <u>after</u>:
    - Sept. 27, 2010 (for 401(k), 403(b) plans)
    - Dec. 31, 2010 (for govt. 457(b) plans)

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Pre-Tax vs. Roth Contributions

- Pre-tax Contributions:
  - Not included in income in year of contribution (elective deferrals, deductible IRA contributions actually <u>decrease</u> the participant's taxable income in year of contribution)
  - Contributions <u>and</u> earnings are taxable in the year of distribution (or conversion)
- Roth Contributions
  - Represent "after-tax" amounts (no decrease in current income)
  - Contributions <u>and</u> earnings are tax-free if distributed in "qualifying distribution"

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“After-Tax” vs. Roth Contributions

- Employee “after-tax” contributions:
  - Made after-tax (no decrease in income)
  - Earnings are tax-<u>deferred</u> (i.e., they are taxable when distributed)
  - No annual limit on amount
- Roth contributions
  - Also after-tax, but earnings are <u>tax-free</u> if distributed in qualified distribution
  - Annual contributions are limited

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Basics of Roth Contribution to Retirement Plans

- Overview
  - What plans can offer them?
  - What are they?
  - Requirements
  - What limits are there?
  - Amendments

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What Plans Can Include a Roth Contribution Feature?

- Plan types:
  - 401(k) plans
  - 403(b) plans
  - 457(b) plans (effective 1/1/2011)
- The plan must also offer a pre-tax deferral option

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What Are Roth Contributions?

- Must be made through a **Qualified Roth Contribution Program** (“QRCP”)
- QRCP Requirements:
  - **Designated Roth Contributions** (“DRCs”): after-tax contributions made in lieu of all or a portion of the pre-tax elective deferrals a participant could otherwise make
  - Designated as Roth contributions when deferred
  - Separate accounting required
  - Separate account must hold only DRCs and earnings; *i.e.*, can’t allocate forfeitures or contributions other than DRCs
  - Separate accounting for DRCs *vs.* converted amounts

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Characteristics of DRCs

- Can they be matched?
  - Yes, but matching contributions must be allocated to pre-tax account
- Can DRCs be recharacterized as pre-tax contributions?
  - No: the election to make DRCs must be made in advance and be irrevocable
- Must the plan also offer pre-tax option?
  - Yes

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Characteristics of DRCs

- Can they be rolled from one plan to another?
  - Yes, but only from one Designated Roth Account to another
- Can they be the source for a loan?
  - Yes
- Can they be the source for a hardship distribution?
  - Yes
- Are distributions, including earnings, entirely tax-free?
  - Yes, but only if "qualified"

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Qualified Roth Distributions

- The Participant must be either:
  - At least 59½,
  - Disabled, or
  - Deceased; ***and***
- The "five-year waiting period" must be complete

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Five-Year Waiting Period

- The period of five consecutive calendar years beginning with the earlier of:
  - **For DRCs made to the distributing plan:**
    - January 1 of the first calendar year in which the participant made a DRC to the Plan
  - **For DRCs rolled over from another plan:**
    - In the case of a rollover of DRCs from Plan A to Plan B, January 1 of the first calendar year in which the participant made a designated Roth Contribution to Plan A that was later accepted into Plan B in a direct rollover

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Limits on Roth Contributions

- DRCs are “in lieu of” pre-tax elective deferrals, so the same limits apply, with a dollar-for-dollar reduction for any pre-tax deferrals:
  - For 2011, the combined limit is **$16,500**
- Catch-up contributions can also be DRCs, but need not be:
  - For 2011, the combined limit is **$5,500**

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Amendments Adding a QRCP

- IRS model amendments for 401(k) and 403(b) plans: Notice 2006-44
- Deadline:
  - Plan must be amended by the end of the plan year in which the QRCP feature is added
  - But see special deadlines (below) for in-plan Roth conversion amendments

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SBJA 2010 “In-Plan” Roth Conversions

- Overview:
  - What are they?
  - Who can do them?
  - What plans can offer them?
  - Requirements
  - Amendments

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What Are In-Plan Roth Conversions, and Who Can Do Them?

- What are they?
  - Optional plan feature
  - Rollover of non-Roth contributions to a separate Roth account
  - Taxable as if distributed to the participant, but exempt from the 10% early withdrawal penalty
- Who can do them?
  - Participants (active or former)
  - Surviving spouses
  - Alternate payees who are spouses or former spouses
- What plans?
  - Any plan with a QRCP

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In-Plan Roth Conversion Requirements

- Available only after September 27, 2010 (after December 31, 2010, for 457(b) plans)
- Plan must provide for:
  - A QRCP (and therefore pre-tax deferrals, as well)
  - In-plan Roth rollovers
  - (More on plan amendments later)
- The amount rolled over must be:
  - An "Eligible Rollover Distribution" of
  - Non-Roth amounts

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Eligible Rollover Distribution

- For example, the distribution must ***not*** be:
  - A “required minimum distribution”
  - A hardship distribution
  - One of a series of substantially equal payments made over a period of 10 or more years (or the lifetimes of the participant and any beneficiary)
  - See *IRS Publication 560* for a complete list of distributions that are not Eligible Rollover Distributions
- Must be:
  - A direct rollover, or
  - A “60-day” rollover

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Must Be from a Non-Roth Account

- The Eligible Rollover Distribution must consist of:
  - Pre-tax elective deferrals,
  - Employee after-tax contributions,
  - Employer matching contributions,
  - Employer profit sharing (nonelective) contributions, or
  - Rollover contributions
  - (Employer contributions must be fully vested)

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Amount Must Be Distributable

- Some contribution types are *not* distributable before:
  - Termination of employment,
  - Age 59½,
  - Death, or
  - Disability
  - (Unless they are Qualified Reservist Distributions)
- These contribution types include:
  - 401(k)/403(b) elective deferrals
  - QNECs
  - QMACs
  - Employer contributions to 403(b)(7) custodial accounts

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Amount Must Be Distributable

- Other contribution types can be distributed sooner
  - General IRS rules for matching and profit-sharing (nonelective) contributions (to qualified plans and 403(b)(1) annuity contracts):
    - Attainment of a specified age, or
    - Occurrence of a specified event:
      - Five years of plan participation, or
      - “Seasoning” of the amount (in the plan for at least two years).
  - Rollovers and after-tax contributions are distributable at any time, if the plan so provides

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Amount Must Be Distributable

- Governmental 457(b) plans:
  - Neither employee nor employer contributions may be distributed before:
    - Age 70 ½;
    - Severance from employment; or
    - Unforeseeable emergency.
  - Limited exception for small, inactive accounts (less than $5,000, with no activity for two years)

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Amendments

- Plan must provide for in-plan Roth conversions:
  - QRCP
  - In-Plan Roth Conversion Option
  - Distribution Options

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Amendment Deadlines

- IRS has provided extended deadlines for the following changes:
  - Adding a QRCP
    - QRCP must be "in place" before any in-plan Roth rollover is made
    - Program is "in place" when participants can make DRCs
  - Allowing Roth accounts to accept rollover contributions
  - Adding an in-plan Roth conversion feature
  - Adding distribution options linked to in-plan conversions
- But ***no*** extended deadline for adding 401(k) feature (must be in place before any amount is deferred)

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Amendment Deadlines

- For 401(k) plans, the later of:
  - Last day of the first plan year in which the amendment is effective, or
  - December 31, 2011
- For safe-harbor 401(k) plans, the later of:
  - Day before the first day of the first plan year in which the amendment is effective, or
  - December 31, 2011
- For 403(b) plans, the later of:
  - End of the plan's remedial amendment period, or
  - Last day of the first plan year in which the amendment is effective
- For 457(b) plans:
  - Still awaiting IRS guidance

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New In-Service Distributions

- Plan can create new “distribution” options that are available only for in-plan Roth conversions
  - Example: Plan that allows in-service distribution at age 65 could allow in-plan conversion (only) option between 59 ½ and 65
  - Example: Plan that does not allow in-service distributions could allow in-plan conversion (only) for individuals with five years of participation
- But existing in-service options ***cannot*** be restricted to in-plan Roth rollovers

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Exceptions to Treatment as Distributions

- In-plan Roth conversions are ***not*** treated as distributions for purposes of:
  - Plan loans
  - Spousal consent
  - Right to defer a distribution of more than $5,000 (rolled amount is taken into account when determining whether participant may be cashed out)
  - Optional forms of payment

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Special Rules for Plan Loans

- Outstanding loans are eligible for in-plan Roth rollover
- No change in repayment terms
- The taxable "distribution" is the outstanding balance on the date of the in-plan Roth rollover

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Conversions - Recordkeeping

- “Converted” amounts must generally be accounted for separately from designated Roth contributions
  - Subsequent distributions must differentiate between DRCs (and earnings) and converted amounts
  - DRCs are generally subject to withdrawal restrictions that cannot be applied to converted amounts

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Conversions - Taxation

- 2010 conversions: 50% of taxable amount is included in income in each of 2011 and 2012, unless taxpayer elects to report it all in 2010
  - Election must be made by due date (with extensions) of 2010 tax return
  - Special income acceleration rule if participant receives a distribution (in 2010 or 2011) of amounts that are not taxable until a later year
  - This income acceleration rule “follows” the money if it is transferred to another plan or to a Roth IRA

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Conversions - Taxation

- Post-2010 conversions are taxable in the year of conversion
  - Taxed on FMV of distribution, less basis
  - No 20% mandatory withholding (if direct rollover) – participant is responsible for estimated tax reporting/payment
  - No 10% early distribution penalty (unless converted amounts are distributed within five years, counting year of conversion)

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Conversions - Reporting

- Plan payor reports the conversion on Form 1099-R for the year of conversion (regardless of any taxpayer election)
  - Include converted amount in Box 1
  - Include taxable amount in Box 2a
  - Include basis in Box 5
  - Enter Code G in Box 7

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Conversions - Administration

- Must amend plan (by relevant deadline) to allow for conversions
- Must communicate conversion option to <u>all</u> participants (via SPD or SMM)
- Must revise Section 402(f) Special Tax Notice to disclose tax treatment of converted amounts
  - Sample language in IRS Notice 2010-84

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IRA Conversions vs. In-Plan Conversions

- Three significant differences:
  - Roth IRAs are not subject to pre-death required minimum distributions (at age 701/2)
  - Conversion to Roth IRA may be recharacterized up to the due date (with extensions) of return for year of conversion
  - Non-qualifying distributions from Roth IRAs are taxed basis first, where distributions from Roth accounts in retirement plans are pro-rata basis/earnings

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Economics of Roth Contributions

- If tax rates remain constant, pre-tax contributions and Roth contributions are mathematically equivalent (on an after-tax basis)
  - If you are in the 30% tax bracket, and can afford \$700 less in take-home pay, you can either (i) defer \$1,000 per month pre-tax, or (ii) designate \$700 per month as Roth contributions. Both will generate the same income at retirement (after-tax) if tax rates remain constant.

Example

- If contributions increase in value by 3x, the $700 Roth contribution will be worth $2,100 (none of which is taxable if distributed in qualifying distribution). The $1,000 pre-tax contribution will be worth $3,000 before tax, or $2,100 after tax. Either way, the participant will have $2,100 of after-tax money at retirement.

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Economics of Roth Contributions

- If tax rates increase, Roth contributions will produce more after-tax dollars at retirement
- If tax rates decrease, pre-tax contributions will produce more after-tax dollars at retirement
- If you max out contributions at $16,500 (or $22,000), Roth contributions will produce more "retirement" dollars, but less money "outside" the plan - - but the sum of both will favor Roth contributions

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Who Should Make Roth Contributions

- Young taxpayers in relatively low tax brackets
- Those expecting to retire in a high tax bracket (or expecting tax rates to rise)
- Those who can afford to defer the max, even as Roth contributions (i.e., they can afford to pay the additional tax with other dollars)

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Who Should “Convert” Pre-tax to Roth

- Those for whom Roth contributions make sense (tax rates, etc)
- Those who have the money (outside the plan or IRA) to pay the income tax on the conversion
- Those who do not intend to spend all of their retirement funds during their lifetime (estate planning purpose)

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Additional Conversion Factors

- Ability to defer/spread income from 2010 conversion over two years
- Duration of Bush-era tax rates
- Conversions (and DRCs) promote tax-diversification at retirement (can chose when to take taxable vs. non-taxable distributions), providing greater control over taxable income in retirement

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