



COMPLIANCE ALERT

ROTH 401(k) AND 403(b) IN-PLAN CONVERSIONS PLAN SPONSORS BEWARE

October 25, 2010

Congress recently passed, and President Obama signed, a new law that permits plans that allow after tax Roth deferrals to also provide for Roth conversions inside of the plan. Although conceptually appealing and perhaps financially beneficial for some plan participants, the passage of this law so late in the year with almost no advance warning has created a minefield of issues, frustration and potential risk for plan sponsors, participants and record keepers. The new law does not include the information and details that plan sponsors and record keepers need in order to make the necessary plan and administrative changes to offer the feature. Regulatory guidance from the Treasury Department (“Treasury”) is needed before plan sponsors can make in-plan conversions available without creating potential problems for their plans and participants. This Compliance Alert highlights some of the most critical issues and potential risks.¹

The new law was passed at the end of September 2010, and was effective immediately. This has created a sense of urgency among some plans and participants who want to be able to take advantage of the two-year special tax treatment for 2010 conversions. However, as we explain below, plan sponsors are being urged to proceed with caution and consider the potential pitfalls for their plans. Many of the issues raised in the new law require guidance from Treasury. Mark Iwry, Senior Advisor to the Secretary of the Treasury and Deputy Assistant Secretary of the Treasury (Retirement and Health Policy), recently encouraged plan sponsors to take a cautious approach. “We’d like to think plan sponsors will pause long enough to see what Treasury says about Roth conversions,” said Mr. Iwry.²

Larry Goldbrum, General Counsel of The SPARK Institute, cautions plan representatives to carefully consider the potential risks that Roth conversions may create for the plan as a whole, and not base their decisions solely on the potential benefits to individual highly compensated employees who may be personally interested in the 2010 special tax treatment.

¹ There are many other unanswered technical questions that industry professionals and record keepers have identified, but such questions are beyond the scope of this brief summary.

² See EBSA to Propose Fiduciary Definition: Other Regulatory Guidance on Horizon, BNA Pension & Benefits Daily (October 20, 2010).

Issues Requiring Regulatory Guidance

The following issues are unresolved and require guidance from the Treasury before they can be properly addressed by plan sponsors and record keepers.

Tax Withholding – An in-plan Roth conversion technically involves a distribution and a subsequent rollover contribution. The new law does not specify whether the distribution portion of the conversion is subject to the mandatory 20% withholding requirement on distributions. Although a waiver exists for a rollover and conversion to a Roth IRA, the Treasury has not yet issued a comparable waiver for in-plan conversions. Absent a waiver, this creates compliance and financial risks for the plan and plan sponsor.

Plan Amendments – Plans that currently offer Roth deferrals must amend their plans if they wish to add the in-plan conversion feature. Plans that currently do not allow Roth elective deferrals must also be amended to allow for designated Roth accounts before an in-plan conversion feature can be added. Amendments to allow for 2010 Roth conversions in a plan that already allows Roth accounts may be made in the “remedial amendment period” (i.e., typically by the due date for the plan’s Form 5500 for the year in which the change is adopted). However, it is unclear whether a plan that does not currently allow Roth accounts can be amended to add them and the in-plan conversion feature in the remedial amendment period or if such an amendment must be adopted before the end of the plan year.

William Bortz, Associate Benefits Tax Counsel at Treasury, has suggested that plan sponsors wait for guidance before drafting any plan amendments. Mr. Bortz has also said that “[t]here’s a concern that if we end up allowing late amendments, you will have moved more quickly than was necessary. I [also] have some concern that you would end up drafting amendments that you later on would regret having drafted.”³

Record Keeping/Administration – The new law does not indicate how and if in-plan conversion amounts must be segregated from regular Roth deferrals for record keeping purposes. If Treasury guidance mandates that they be segregated, record keepers must upgrade their systems to accommodate the new requirement. The vast majority of record keepers do not have the system functionality to do this and, absent regulatory guidance, it is unclear how to proceed.

Fred Reish, of the law firm of Reish & Reicher, notes that “[l]ogically, additional guidance should require a separate account for tracking the converted Roth amounts; however, laws are not always interpreted in logical ways and the guidance may have surprises.” Mr. Reish suggests that “[t]he better approach, for risk management purposes, is to wait until the guidance is issued.”

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³ See Treasury Tax Counsel Advises Sponsors To Await Guidance on Roth Conversions, BNA Pension & Benefits Daily (October 21, 2010).

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Additional Issues

Plan sponsors should consider these other issues in making a decision about Roth in-plan conversions.

No Recharacterization – An in-plan Roth conversion is irrevocable and cannot be “recharacterized” after it is made. In contrast, a Roth IRA can be recharacterized (i.e., revoked) before the participant’s tax filing deadline. The ability to recharacterize can be helpful to participants who convert and later realize that they are unable to pay the tax liability on the conversion. It can also be helpful if a significant investment loss occurs in the account after the conversion takes place. Plan sponsors should consider whether they will be able to fully inform participants about these implications between now and December 31, 2010.

Conversion Eligibility – Although some confusion has been reported regarding what amounts are eligible for in-plan conversions, the legislation is clear that conversions are only available for amounts otherwise eligible for a distribution under the plan. Additionally, the law does not expressly allow a plan to add an in-service distribution feature that can only be used for the purpose of making an in-plan conversion.

Roth IRAs – Roth IRA rollovers remain a viable option for otherwise eligible participants who want to effect a 2010 conversion to a Roth account and take advantage of the special two-year tax treatment. This option involves significantly less risk for the plan and the plan sponsor, pending further regulatory guidance.

There are many other unanswered technical questions that industry professionals and record keepers have identified but such questions are beyond the scope of this brief summary.

Conclusion

Plan sponsors should consider the issues summarized in this Compliance Alert carefully, be mindful of the implications to the plan as a whole, and consult with their counsel if they remain interested in permitting 2010 conversions. The consequences of making a wrong guess on how to handle some of these issues could have negative implications for the plan and participants. The SPARK Institute is preparing a request for guidance to Treasury regarding the open issues. Once the issues are resolved, plan sponsors can implement in-plan Roth conversions with reasonable confidence that they are doing so properly.

THIS COMPLIANCE ALERT IS FOR INFORMATIONAL PURPOSES ONLY AND SHOULD NOT BE CONSTRUED AS LEGAL OR TAX ADVICE. CONSULT YOUR OWN ADVISORS REGARDING YOUR SPECIFIC ISSUES AND SITUATION.

About The SPARK Institute

The SPARK Institute represents the interests of a broad based cross section of retirement plan service providers and investment managers, including record keepers, banks, mutual fund companies, insurance companies, third party administrators, trade clearing firms and benefits consultants. Members include most of the largest firms that provide record keeping services to employer-sponsored retirement plans, ranging from one participant programs to plans that cover tens of thousands of employees. The combined membership services more than 62 million employer-sponsored plan participants.

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