PUBLICATION

Congress Again Expands Rules Governing Roth Conversions Within Certain Retirement Plans

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The American Taxpayer Relief Act of 2012 (Act), just signed by the President on January 2, 2013, expands the rules to allow any amount in a non-Roth account of a plan described below to be converted to a Roth account. While the new rules still restrict conversions to vested amounts, the Act allows all vested assets in a plan to be converted, whether or not a distribution is otherwise available.

Background

Prior to the Small Business Jobs Act of 2010 (2010 Tax Act), the only technique for a participant in a 401(k), 403(b) or 457(b) plan to convert all or a portion of that participant's untaxed vested account to a Roth account was to roll that portion of the participant's account into a Roth IRA in connection with a distribution from the plan. That technique is still viable.

In an expansion of this technique, the 2010 Tax Act provided that, under limited circumstances, a qualified participant in a plan governed by Sections 401(k), 403(b) or 457(b) of the Code could convert untaxed assets in the participant's account in a plan to a Roth account in that plan. There are two methods under the 2010 Tax Act by which a plan could allow qualifying participants to convert their accounts to Roth accounts in the same plan: (i) a direct rollover to the Roth account in the plan (essentially a deemed distribution out of the plan with a deemed rollover back into a different account in the same plan) or (ii) an actual distribution of funds to the participant who then had 60 days to roll the funds back into the Roth account in the same plan. Of course, the latter type of rollover has the added disadvantage of being subject to mandatory 20 percent federal income tax withholding. Specific guidance governing rollovers to designated Roth accounts in the same plan is found in IRS Notice 2010-84. According to that guidance, only vested amounts may be converted and only plans that maintain a qualified Roth contribution program at the time conversion is made were allowed to make such a conversion. Under the Code and Notice 2010-84, a conversion could only be made when there was a distributable event and the plan document allowed for rollover distributions.

Act's Expansion

As stated above, the Act just signed by the President expands these rules effective January 1, 2013. Under such expansion, as authorized by the Act, any vested amount in a 401(k), 403(b) or 457(b) plan may be converted to a Roth account, whether or not a distribution is otherwise available for the amount converted. Thus, very young and very new participants are now eligible to convert vested accounts into Roth accounts in the same plan, while the 2010 Tax Act rules generally restricted conversions to older and longer service participants. Of course, prior to the conversion, the plan would still need to include all necessary language regarding contributory Roth accounts. The amount converted will be included in the participant's gross income and subject to tax in the year of the conversion. The taxable amount is the fair market value of the conversion reduced by any basis the participant has in the assets. Amounts so converted are not subject to the 10 percent early distribution penalty nor will mandatory 20 percent withholding apply to the conversion.

Participants should consider making this conversion because amounts distributed from a Roth account are not subject to income tax at the time of distribution, provided the statutory rules for the duration of the account are first satisfied. Under certain circumstances, especially where applicable tax rates are expected to increase in later years, this may result in a tax savings to a participant.

Should you have questions regarding this conversion expansion authorized by the Act, or should you wish to discuss any other aspect of the Act, please contact any of the following attorneys in the Firm's Tax Department.