IRS Offers Roth 401(k), 403(b) Guidance

On Friday the IRS issued Notice 2010-84, containing guidance for 401(k) and 403(b) plans about in-plan Roth rollovers.

On September 27, President Obama signed the "Small Business Jobs and Credit Act of 2010," which allows the taxable transfer of a participant's contributed pre-tax money to an in-plan Roth option. Previously, a participant who wanted to convert to a Roth had to do it outside a plan, to a Roth IRA.

The IRS notes that 401(k) and 403(b) plans have extended deadlines to amend to allow 2010 in-plan Roth rollovers if the amendment's effective date is the date the plan first operated in accordance with that amendment; 401(k) plans have until the later of the last day of the year in which the amendment is effective or December 31, 2011, while safe harbor 401(k) plans have until the later of the day before the first day of the plan year in which the safe harbor plan provisions are effective or December 31, 2011.

As for 403(b) plans, they have until the later of the plan's remedial amendment period (described in Announcement 2009-89) or the last day of the first plan year in which the amendment is effective. Additionally, the IRS notes that a §457(b) government plan may adopt an amendment to include a designated Roth account after December 31, 2010, and then allow in-plan Roth rollovers.

The IRS notice states that, besides plan participants, surviving spouse beneficiaries and alternate payees who are current or former spouses are also eligible to do an in-plan Roth rollover. It also notes that there are two types of in-plan Roth rollover; a direct rollover, that occurs when the plan trustee transfers an eligible rollover distribution from a participant's non-Roth account to the participant's designated Roth account in the same plan, and an in-plan Roth 60-day rollover, which occurs when the participant deposits an eligible rollover distribution within 60 days of receiving it from a non-Roth account into a designated Roth account in the same plan.

According to the IRS Notice, participants may only roll over eligible rollover distributions from a non-Roth account to a designated Roth account in the same plan. Additionally, the IRS notes that a plan can be amended to allow new in-service distributions from the plan's non-Roth accounts conditioned on the participant rolling over the distribution in an in-plan Roth direct rollover. However, the plan cannot impose this condition on any existing distribution options available under the plan.

The IRS notes that a plan may have to hold in-plan Roth rollovers for a participant in a separate account maintained solely for these rolled over amounts.

A distribution rolled over as an in-plan Roth direct rollover is not treated as a distribution for the following purposes:

- Transferring a plan loan to the designated Roth account without changing its repayment schedule;
- Requiring spousal consent;
- Requiring a participant's consent before an immediate distribution of an accrued benefit of more than $5,000; and
- Eliminating a participant's right to optional forms of benefit.

Written Explanation (402(f) Notice)

The IRS notes that if a plan offers in-plan Roth rollovers, it must include a description of this feature in the written explanation (402(f) Notice) the plan provides to participants who receive an eligible rollover distribution.

The IRS notice also clarifies that in-plan Roth rollovers are not subject to the 10% additional tax on early distributions under Code §72(t) and an in-plan Roth direct rollover is not subject to the mandatory 20% withholding under Code §3405(c).

The IRS notes that a special recapture rule applies when a plan distributes any part of the in-plan Roth rollover within a 5-taxable-year period, making the distribution subject to the 10% additional tax on early distributions under Code §72(t) unless an exception to this tax applies or the distribution is allocable to any nontaxable portion of the in-plan Roth rollover. The notice goes on to explain that the 5-taxable-year period begins January 1 of the year of the in-plan Roth rollover and ends on the last day of the fifth year of that period. This special recapture rule does not apply when the participant rolls over the distribution to another designated Roth account or to his or her Roth IRA but does apply to a subsequent distribution from the rolled over account or IRA within the 5-taxable-year period.

Special Rules for 2010

The IRS notes that a participant generally reports the taxable amount (fair market value of the distribution minus the employee's basis in the distribution) of an in-plan Roth rollover in the taxable year in which he or she receives the distribution. However, for in-plan Roth rollovers done in 2010, the participant:

- reports half of the taxable amount in 2011 and the other half in 2012 (2-year income spread), or
- elects to report the entire taxable amount in 2010.

The IRS notice also provides guidance for participants who make an in-plan Roth rollover in 2010.

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