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December 6, 2010

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In-Plan Roth Rollovers1



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IRS Issues Guidance on In-Plan Roth Rollovers

The IRS has issued Notice 2010-84 (“the Notice”), providing guidance on the new employer-sponsored retirement plan provision that allows participants to change the character of their plan assets from pretax—including basis—to Roth status within the plan. The IRS identifies this status change as an “in-plan Roth rollover” to a designated Roth account within the plan. Such in-plan rollovers were made possible by enactment of the Small Business Jobs Act of 2010, effective after September 27, 2010. Following is Ascensus’ analysis of the Notice. Questions raised—or not answered—by Notice 2010-84 are being compiled by Ascensus and retirement industry groups with which we are affiliated, in hopes that answers may be forthcoming from the IRS. Watch Ascensus’ *Retirement Plans Bulletin* for updates.

What is an in-plan Roth rollover?

An in-plan Roth rollover is the movement of assets to a designated Roth account within an employer’s plan from an account other than a designated Roth account within the same plan. Plan participants and spouse beneficiaries (and spouse alternate payees) may either roll over assets directly within a plan, or roll over a distribution within 60 days of receipt (indirect rollover).

What amounts are eligible for in-plan Roth rollovers?

A participant’s vested balance from any plan source (e.g., elective deferrals, profit sharing, match, after-tax) is eligible for an in-plan Roth rollover if the statute and plan language allow distribution of such balance, and the plan is amended to allow in-plan rollovers. For example, a still-employed participant’s elective deferrals are not eligible for in-plan rollover until age 59½, or upon disability, death, or eligibility for a qualified reservist distribution (permissible distribution triggers for elective deferrals). Other amounts subject to less restrictive distribution triggers under the plan can be rolled over at any time permitted by plan provisions.

A plan may permit in-plan Roth rollovers when amounts could be eligible for distribution, even though such amount is not distributable to the

participant under the terms of the plan. For example, plan provisions (as amended) may permit in-plan Roth rollovers of elective deferrals at age 59½, even though the plan does not permit an actual distribution to a participant at age 59½. This feature is intended to allow assets to gain Roth status yet prevent money from leaving employer plans.

Is an in-plan Roth direct rollover treated as a distribution for all purposes?

Apart from the requirement that an in-plan Roth rollover must be reported on Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, and described in the 402(f) distribution notice, such an event is not treated as a distribution for several purposes. These include the following.

- Spousal consent that would be required for an actual distribution in a form other than an annuity is not required for an in-plan direct Roth rollover.
- An in-plan direct rollover to a designated Roth account will continue to be counted in determining whether the participant's balance may or may not be cashed out of the plan.
- An amount that a participant was entitled to receive prior to an in-plan Roth direct rollover must continue to be available for distribution to the participant after the rollover.
- An in-plan Roth rollover is not subject to mandatory 20 percent withholding.

What are the tax consequences of an in-plan Roth rollover?

An in-plan Roth rollover is included in income and taxed for the year of the rollover, to the same extent that it would be taxed if rolled over to a Roth IRA. Therefore, it generally will be taxable, adjusted for any basis in the employer plan. Special rules apply for employer securities and loans. Net unrealized appreciation (NUA) in employer securities that are transferred to a designated Roth account in an in-plan Roth rollover will be taxed in the current year. A loan balance rolled over to a designated Roth account will be included in income, adjusted for basis (as any in-plan Roth rollover assets), but the loan will retain all of its previous provisions.

An exception to the general year-of-taxation rule exists for 2010 in-plan Roth rollovers. In-plan Roth rollovers executed by December 31, 2010, will have one-half of the rollover amount taxed in 2011 and one-half taxed in 2012, unless a participant elects—when filing his or her annual income tax return—to be taxed in 2010. Note, however, that delayed equal taxation in 2011 and 2012 for a 2010 in-plan Roth rollover may only be maintained if an amount attributable to the 2010 rollover is not distributed before 2012.

Does the 10 percent early distribution penalty tax apply to in-plan Roth rollovers?

Similar to when rolling over (converting) non-Roth assets to a Roth IRA, following an in-plan Roth rollover there is a five-year “recapture” period during which a distribution attributable to that rollover cannot be distributed without being subject to the 10 percent early distribution penalty tax on pre-59½ distributions. The five-year recapture period begins on January 1 of the taxable year in which the rollover took place, and ends on December 31 of the fifth taxable year. If a distribution attributable to the rollover occurs before December 31 of that fifth year, the distribution amount is subject to the additional 10 percent tax, unless one of the qualified plan penalty exceptions applies.

How is an amount that is distributed following an in-plan Roth rollover attributed to such rollover, for purposes of the acceleration rules and the additional tax on early distributions?

The Notice makes clear that the Internal Revenue Code's basis recovery rules apply to distributions from employer plans that contain in-plan Roth rollovers. When distributions are taken, Roth amounts of all types are aggregated for determining the tax obligation under the basis recovery rules. The Notice indicates that “first in, first out” ordering rules may be applied to in-plan Roth rollovers that occur in separate tax years (similar to Roth IRAs). This can be beneficial for potential relief from the 10 percent early distribution penalty tax, which in-plan Roth rollovers are subject to for a five-year period. But the first-in,

first-out rule is available only if there is separate accounting maintained for in-plan Roth rollovers. (The details of how separate accounting is to be done are not addressed in this Notice.)

How are in-plan Roth rollovers reported?

Limited guidance on reporting in-plan Roth rollovers was posted on the IRS website on November 22, 2010. It deals only with 2010 reporting, and with direct rollovers. The posting indicates that such transactions are reported using Code G (direct rollover) in Box 7 of Form 1099-R, and that the gross amount rolled over is to be reported in Box 1, the taxable amount in Box 2a, and any basis reported in Box 5 (employee contributions). If there is a distribution subsequent to an in-plan Roth rollover, the Form 1099-R generated for that transaction must identify (in the blank box to the left of Box 10) any amount of the distribution that is allocable to a 2010 in-plan Roth rollover.

Is a plan amendment providing for in-plan Roth rollovers in a 401(k) plan required to be adopted by the end of the 2010 plan year?

It is not necessary to amend a plan to allow in-plan Roth rollovers by December 31, 2010, in order to allow such rollover transactions during 2010. Although standard amending procedure for discretionary amendments is to adopt by the last day of the plan year in which a provision first becomes effective, the IRS is conditionally extending the deadline related to in-plan Roth rollovers to the later of such effective date, or December 31, 2011. In order to qualify for this extension, the effective date of an amendment permitting in-plan Roth rollovers must be retroactive to the date that the plan first operates to allow such in-plan rollovers.

This deadline applies to amendments other than the initial establishing of a cash-or-deferred-arrangement

in a plan. Examples of amendments qualifying for the extension include the following.

- A provision that permits deferrals to a designated Roth account (allows Roth deferrals)
- A provision that allows rollovers in general to a designated Roth account
- A provision that permits in-plan Roth rollovers

What is the deadline for adopting a plan amendment providing for in-plan Roth rollovers in a 403(b) plan?

A 403(b) plan that has qualified for a remedial amendment period (RAP) by satisfying the conditions of IRS Announcement 2009-89 may amend to permit in-plan Roth rollovers by the later of its RAP deadline, or the last day of the plan year in which it first permits in-plan Roth rollovers. Consequently, a 403(b) plan that has not qualified for a RAP must amend by the last day of the plan year in which it first permits in-plan Roth rollovers. Similar to 401(k) plans, in order to qualify for this extension, the effective date of an amendment permitting in-plan Roth rollovers must be the date that the plan first operates to allow such in-plan rollovers.

Must a plan have a Roth contribution program in place when first permitting in-plan Roth rollovers?

Yes; to allow in-plan Roth rollovers, a qualified Roth contribution program must be in place operationally when such rollovers are first permitted. "In place" means that participants have the opportunity to defer into designated Roth accounts (Roth 401(k), Roth 403(b), or Roth 457(b) accounts) any compensation that would be eligible for deferral as of that date. In other words, the ability to make in-plan Roth rollovers must coincide with the ability to make designated Roth account contributions from eligible compensation.



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