Direct Rollovers From 401(k) and 403(b) Plans to Roth IRAs

This compliance alert will focus on what benefit managers of 401(k) (and other qualified plans), 403(b) plans and governmental 457(b) plans should know about direct rollovers to Roth IRAs, particularly in 2010 when special rules apply.

Let's start with a brief discussion of the conversion of traditional individual retirement accounts ("IRAs") to Roth IRAs in 2010.

This is the hottest financial planning topic in 2010.

Why?

Because for taxable years beginning in 2010 there is no modified adjusted gross income limit or joint income tax filing requirement (if married) in order to be entitled to convert a traditional IRA into a Roth IRA. Prior to 2010, a traditional IRA could not be rolled over to a Roth IRA unless the individual's modified adjusted gross income was $100,000 or less and, if the individual was married, filed a joint tax return. For tax years starting in 2010, these limitations, which also apply to rollovers from qualified retirement plans, 403(b) plans or governmental 457(b) plans,[1] no longer apply.

Converting a traditional IRA to a Roth IRA, or the direct rollover of a 401(k) account (other than a designated Roth 401(k) account) in 2010 will result in the amount of the rollover (less any after-tax amounts) being taxed. For 2010, however, a special taxation rule applies. This special rule permits the taxable amount of the rollover to be deferred from gross income until 2011 and 2012, at which time it will be included in income in equal amounts in those two years (unless the individual elects to include the entire amount in gross income in 2010).

What are some of the other tax advantages of the rollover of an eligible rollover distribution from a 401(k) plan to a Roth IRA?

- The ten percent (10%) additional income tax on early distributions will not apply (unless the amount rolled over to the Roth IRA is withdrawn within five years from the year for which the rollover is made, counting from January 1 of the year of the rollover from the 401(k) plan).

[1] Generally, any reference to 401(k) plans in the remainder of this compliance alert also applies to 403(b) plans and governmental 457(b) plans. Furthermore, the reference to 401(k) accounts assume they do not include designated Roth 401(k) accounts or designated Roth 403(b) accounts, which may be rolled over to Roth IRAs, without being subject to the rules discussed in this compliance alert.

- Later withdrawals from the IRA that are "qualified distributions" will not be taxed (including investment earnings after the rollover). A "qualified distribution" is a withdrawal from the Roth IRA after an individual (1) is age 59-1/2 or older (or after the individual's death or disability, or as a result of the withdrawal of up to $10,000 as a qualified homebuyer distribution); and (2) has had a Roth IRA for at least five years. In applying this five year rule, the counting begins with the first year for which a contribution was made to a Roth IRA. [2]

- Additionally, minimum required distributions from a Roth IRA are not required during the individual's lifetime (however minimum distributions are required after the individual's death).

How may a rollover to a Roth IRA be accomplished?

By any of the following three methods:

- A direct rollover;

- An indirect rollover within sixty days of the date of distribution (which would be an approach for an individual who wants to pay the federal and state income taxes from the distribution and only roll over the remaining amount to a Roth IRA); and

- A trustee to trustee transfer (which may be appropriate if the trustee of the 401(k) plan and the trustee of the Roth IRA are the same).

When is a rollover from a 401(k) Plan not permitted?

- A participant in a 401(k) plan may only roll over an amount that is both an eligible rollover distribution and a benefit that is payable from the 401(k) plan because of a distribution event, such as retirement, termination of employment, or an in-service withdrawal after age 59-1/2 for any reason, other than financial hardship. The following distributions, however, are examples of distributions that are *not* eligible rollover distributions:

    - Minimum required distributions (generally, after age 70-1/2 or retirement, if later, or death); and

    - Periodic installment payments over ten years or more, or the lifetime or life expectancy of you or you and your beneficiary.

[2] A distribution from a Roth IRA that is not a qualified distribution will be taxed to the extent of the investment earnings after the rollover, including the ten percent (10%) additional income tax on early distributions (unless an exception applies).

An ineligible rollover to a traditional IRA or a Roth IRA is includable in gross income and is subject to a six percent (6%) excise tax each year until the ineligible amount is withdrawn from the IRA.

Can a direct rollover from a 401(k) plan to a Roth IRA be recharacterized as a traditional IRA?

Yes, provided the following requirements are satisfied:

- the Roth IRA to traditional IRA transfer is made by the due date (including extensions) of the individual's tax return for the year in which the direct rollover was made;
- the Roth IRA to traditional IRA transfer includes the investment income or losses allocable to the Roth IRA;
- the Roth IRA to traditional IRA transfer is reported on the individual's federal tax return for the individual's applicable tax year; and
- the IRA is treated as a traditional IRA for the year of the IRA transfer.[3]

Can a 401(k) account be converted (or recharacterized) *within* a 401(k) plan to a designated Roth 401(k) account?

Not at the present time. However, the U.S. Senate recently passed a bill to permit participants in a 401(k) plan who have experienced a distribution event to convert a traditional pre-tax 401(k) account into a designated Roth 401(k) account *within* the 401(k) plan (and include the taxable portion of the conversion in gross income). This provision is not included in a similar bill passed by the U.S. House of Representatives. Therefore, this provision will only be enacted if it is included in a House/Senate Conference bill.

What is the primary reason a 401(k) plan participant may decide to elect a taxable rollover to a Roth IRA, rather than a nontaxable rollover to a traditional IRA?

A participant who is entitled to receive an eligible rollover distribution may prefer a taxable rollover to a Roth IRA because the participant believes that later tax free qualified distributions from the Roth IRA will be more tax advantageous (due to higher tax rates on his/her income when IRA withdrawals are made). Conversely, a participant may prefer a nontaxable rollover to a traditional IRA because the participant believes that a tax deferred rollover will be more tax advantageous (due to lower tax rates on his/her income when withdrawals are made).

[3] A 401(k) plan participant age 70-1/2 or older who has earned income may also contribute to a Roth IRA or may convert a traditional IRA into a Roth IRA, provided the minimum required distribution is made first and is not rolled over.

How can a participant make such a complex decision?

By consulting with a qualified financial advisor and comparing the tax implications of each alternative through an online Roth IRA calculator, which may be accessible from the 401(k) plan's service provider or other financial advisor.

What can plan sponsors and third party administrators do to help?

- Provide the applicable I.R.C. 402(f) *Your Rollover Options* Notice (which is in IRS Notice 2009-68) to participants who are entitled to an eligible rollover distribution.

- Suggest the participant consult a qualified personal financial or tax advisor.

- Encourage the participant to consider all the tax implications of the alternatives and explore "what if" scenarios through an online Roth IRA calculator.

Here is a link to IRS Notice 2009-68, with two "Your Rollover Option" model notices.

http://www.irs.gov/pub/irs-drop/n-09-68.pdf

Please let us know if we can be of assistance.

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