September 29, 2010

Tax Now, or Tax Later? New Law Allows the Taxable Transfer of Pre-Tax Money to a Plan Roth Account

On Monday September 27, 2010, the President signed into law the Small Business Jobs Act of 2010 ("Act"), a law which includes a revenue-raising provision that will allow participants to transfer money within a retirement plan from a pre-tax account into a Roth account, subject to certain limitations and the payment of taxes on the transfer. Participants may be interested in converting pre-tax accounts to a Roth account because future earnings in a Roth account may be withdrawn tax-free. Previously, a participant could convert a pre-tax account to a Roth account only by rolling money out of the plan and into a Roth IRA or a Roth account in another retirement plan.

Plan Considerations. Plans must have a qualified Roth contribution program (i.e, an option allowing participants to direct some or all of their elective deferrals into a Roth account) in order to allow participants to transfer pre-tax money already in the plan into a Roth account. A plan that does not otherwise have a Roth option is not permitted to establish a Roth account within the plan solely to accept such transfers. Moreover, a plan that already has a Roth option is permitted, but is not required, to allow the taxable transfer of pre-tax funds into a plan Roth account.

Though this part of the Act has an immediate effective date, plan amendments will be necessary to allow the taxable transfer of pre-tax money into a plan Roth account. The IRS will likely provide employers with a remedial amendment period so that individuals may elect to transfer money to a plan's Roth account for the year 2010.

Not all pre-tax money is eligible for transfer into a Roth account. Amounts to be transferred to a plan's Roth account must otherwise be available as a distribution under the plan. If the money is subject to distribution restrictions, it cannot be transferred into a plan Roth account under the new law. Employers are free, however, to expand their distribution options to allow, for example, in-service distributions or distributions prior to normal retirement age. A plan may even condition eligibility for a new distribution option on a participant's election to have the distribution directly transferred to a plan Roth account.

Individual Tax Considerations. The transfer of money to a plan Roth account is not a tax-free event. The individual must include the amount of the transfer in gross income, although the amount is generally not subject to the ten percent early-distribution penalty. If the transfer is made during the 2010 tax year, the amount of the transfer may be included in gross income in the tax years 2011 and 2012 in equal amounts, unless the taxpayer elects to include the entire amount in 2010 income. In future years, the entire amount of the transfer will be included in that year's gross income.

Reporting Requirements. The employer maintaining a plan or the plan administrator will be subject to additional reporting requirements so that the IRS may ensure the proper reporting of gross income on transfers to plan Roth accounts.

Other Provisions of the Law. Also as part of this Act, governmental 457(b) plans, which could not previously include a Roth option as part of their plans, will be permitted to adopt a Roth program and participate in the transfer option described above after December 31, 2010.

For assistance, or if you have questions about any other employee benefit matters, please contact a member of our Benefits Law Group.

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