REGULATIONS

IN-PLAN ROTH ROLLOVERS

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On November 26, 2010, the IRS published much-needed guidance regarding in-plan Roth rollovers (IRRs) in the form of Notice 2010-84.

As a result of the Small Business Jobs Act of 2010 (SBJA), qualified §401(k) plans and §403(b) plans are permitted to offer IRRs, allowing conversions from pre-tax money sources to a designated Roth source under the same employer's plan.

Governmental §457(b) plans are now also permitted to contain a designated Roth program where participants can make post-tax Roth deferrals and elect IRRs in the same manner as §401(k) plans and §403(b) plans. Prior to the enactment of the SBJA of 2010, eligible rollover distributions of pre-tax money sources within an employer's plan could be converted only to a Roth IRA. With respect to eligible rollover distributions after September 27, 2010, such conversions can be accomplished within the same employer's plan, thus preserving the participant's overall retirement savings inside the same plan without the need of establishing a Roth IRA to hold a conversion.

What's an in-plan Roth rollover?

An IRR is an eligible rollover distribution from an individual's plan account made after September 27, 2010, other than from a designated Roth account, that is rolled over to the individual's designated Roth account in the same employer's plan. The IRR can be accomplished by either: (1) a direct rollover (an in-plan Roth direct rollover); or (2) a distribution to the individual who then rolls over the funds into the individual's designated Roth account in the same employer's plan within 60 days (an in-plan Roth 60-day rollover).

What amounts are eligible for IRRs?

A plan participant must have a distributable event that is permitted under the terms of the employer's plan, and such event must be otherwise eligible for rollover as defined under §402(c)(4) of the Code. Thus, the general rule limits the amount of an IRR to the vested amount being held in the plan on behalf of a plan participant (other than amounts held in a designated Roth account).

In the case of a participant who's still working, an IRR from the participant's elective deferral account is permitted only if the plan allows for a distribution when the participant has attained age 59½, has died or become disabled, or receives a qualified reservist distribution. A participant's elective deferral account includes safe harbor matching, safe harbor nonelective, qualified matching, and qualified nonelective employer contributions.

Although a plan permits a distribution and such distribution meets the definition of an eligible rollover distribution, the plan must also permit an IRR. Certain retroactive plan amendments are permitted for this purpose.

Is a direct IRR considered a distribution for all purposes?

No, an in-plan direct rollover merely changes the account under which an amount is being held on behalf of the participant, and also changes the tax consequences of such amounts for subsequent distributions. Thus, an IRR that is made as a direct rollover is not considered a distribution for the following purposes:

- An existing plan loan that is transferred in an IRR direct rollover without changing the repayment schedule is not treated as a new loan.
- If the plan is subject to the annuity requirements of §401(a)(11), spousal consent isn't required in connection with an IRR that is a direct rollover.
- A §411(a)(11) Notice, relating to a participant's consent before an immediate distribution of an accrued balance greater than $5,000, is not triggered by the IRR that is made as a direct rollover. However, the IRR account continues to be considered in determining whether the participant's accrued benefit exceeds $5,000.
- A participant who already had a right to take a distribution under the terms of the plan prior to the IRR that is made as a direct rollover can't have this right eliminated merely because of the IRR.

Can a plan add an IRR provision for amounts that are not already distributable under the terms of the plan that would be an allowed distribution under the Code, if the plan is amended to provide new, additional distribution options?

Yes, but an employer must be cautious. A plan can be amended to add new, permissible distribution options for purposes of an IRR that is a direct rollover. For example, a plan that does not currently permit an in-service distribution from a participant's elective deferral account when the participant reaches age 59½ may be amended to permit an IRR that is a direct rollover, but not permitting an actual distribution of these amounts from the plan. However, a plan cannot be amended to restrict a distributable amount to be made only as an IRR direct rollover, if the terms of the plan already permitted such a distribution. Such a restriction would violate the protected benefit rules of §411(d)(6).

Must the §402(f) Rollover Notice include a description of an IRR for amounts that are eligible rollover distributions?

Yes, the required §402(f) Rollover Notice must be updated to include a description of an IRR for amounts that are eligible rollover distributions, including any permissible restrictions for amounts that may only be made as an IRR direct rollover.

After a plan participant elects an IRR, can the amount be recharacterized or can the participant in any way change his or her mind?

Unfortunately, the answer is no. Unlike conversions to a Roth IRA where the taxpayer can elect a recharacterization under the rules of §408A(d)(6), IRRs are not permitted to be reversed.

What are the tax consequences of an IRR?

The taxable amount of an IRR is the amount that would be includible in gross income in the same manner as if the amount were converted from the plan to a Roth IRA. In general, the taxable amount of the IRR is the total amount of the IRR reduced by any basis (such as after-tax employee contributions) and the rules of IRS Notice 2009-75 apply. For example, if the IRR includes employer securities attributable to employee contributions, the fair market value includes any net unrealized appreciation on the employer securities. Also, if an outstanding loan balance is part of an IRR, the taxable amount of the IRR includes that balance.

Are IRRs that are made as direct rollovers subject to 20 percent

mandatory tax withholding?

No. Although the IRR made as a direct rollover is a taxable event, it's not subject to the 20 percent mandatory tax withholding requirements of §3405(c) because the amount was made as a direct rollover. However, a taxpayer should consult with his or her tax advisor to determine if the estimated tax deposit rules apply.

If a taxpayer is using the two-year spread on a 2010 IRR, but then dies or divorces before the entire taxable amount of the 2010 IRR is includible in the participant's gross income, do special rules apply?

Yes, the rules of IRS regulations §1.408A-4, Q&A 11 and §1.408A-6, Q&A 6 apply in these cases. These regulations provide that:

- If the participant dies before the entire taxable 2010 IRR has been includible in the participant's gross income, the remaining taxable amount of the 2010 IRR is accelerated and reported on the final tax return filed on behalf of the decedent. However, if the participant's surviving spouse is the sole beneficiary, the surviving spouse may continue the two-year spread, unless a distribution to the surviving spouse results in the income acceleration rule.

- If the participant who was married in 2010 subsequently files separately or divorces before the entire taxable 2010 IRR has been includible in the participant's gross income, the participant must continue to include the original taxable 2010 IRR in gross income ratably over 2011 and 2012, unless accelerated due to taking a distribution or death.

How does the 10 percent recapture tax rule apply for subsequent distributions from a designated Roth account of an amount that is allocable to an IRR?

At the point of the IRR, the 10 percent premature distribution tax under §72(t) does not apply, although the taxable amount of the IRR must be included in the taxpayer's gross income. A special rule applies, however, if any distribution is made from the designated Roth account that is allocable to the IRR before that specific IRR has remained in the designated Roth account for a five-year period. For purposes of this five-year recapture rule, the five-year period begins on January 1 of the year of the IRR and ends on December 31 of the fifth year.

For example, Carol makes a taxable IRR during 2011 in the amount of $20,000. For this five-year recapture rule, the five-year period begins on January 1, 2011, and ends on December 31, 2015. On April 30, 2015, she takes a distribution that includes $6,000 allocable to the taxable amount of the 2011 IRR. If Carol is under age 59½ at the point of the 2015 distribution (or doesn't meet any other exception to the 10 percent additional tax) she would owe a tax equal to $600 (10 percent X $6,000) on her 2015 income tax return, although the $6,000 was already included in her gross income in 2011. Had Carol waited until 2016 to take the $6,000 distribution (assuming that the amount is permitted to be distributed), the five-year recapture period would have been met with respect to her 2011 IRR and she wouldn't owe the 10 percent premature tax for 2016.

Remember that this five-year recapture period applies to each IRR and is totally separate from the five-year aging rule when determining whether the participant is receiving a qualified distribution from the designated Roth account. For example, Rocky makes an IRR on February 16, 2011. Rocky also made his first Roth elective deferral on October 1, 2010. The five-year period for determining whether a distribution is a qualified distribution began on January 1, 2010. The five-year period for determining whether the 10 percent recapture tax applies on his 2011 IRR began on January 1, 2011.

How is a distribution made from a designated Roth account allocated to the taxable amount of an IRR for purposes of the income acceleration rule and the five-year recapture rule described above?

Solely for purposes of the income acceleration rule and the five-year recapture rule, an amount distributed from a designated Roth account that is paid from a separate account maintained solely for an IRR (an IRR account) is treated as attributable to an IRR. This is to the extent that the amount distributed constitutes a pro rata basis recovery calculation by looking first at the participant's total account balance and total earnings in the entire designated Roth account.

Example:

- Pete, age 45, makes a $100,000 direct IRR as a permissible in-service distribution from his profit sharing account and his after-tax employee contribution account.

- Of the $100,000 total IRR, $90,000 is taxable and $10,000 represents his principal amount of his after-tax employee contributions.

- Pete is using the two-year spread.

- With no distributions, Pete includes $45,000 into his 2011 gross income and $45,000 into his 2012 gross income.

- Pete doesn't owe the 10 percent premature tax on the $90,000 taxable IRR.

- The plan doesn't withhold any taxes since the IRR is a direct rollover within the plan.

- The plan separately accounts for the IRR.

- The plan issues a 2010 Form 1099-R to report this IRR by including $100,000 in Box 1; $90,000 in Box 2a; $10,000 in Box 5; and Code G in Box 7.

- Pete files a 2010 Form 8606 with his tax return reporting the IRR.

- At the time of the IRR, Pete also has a Roth elective deferral account that's being separately accounted for under the plan and contains Pete's Roth deferrals and earnings attributable to his Roth deferrals.

- Before the end of 2010, Pete requests an in-service distribution of the maximum amount possible from his designated Roth account.

- The only source available from his designated Roth account is the total account balance of the IRR source, which has been separately accounted for.

- Pete isn't eligible to take a distribution from his Roth deferral account since he's only age 45 and hasn't severed employment, died, become disabled, or requested a qualified reservist distribution.

- At the time of the requested distribution, Pete's total designated Roth account comprises the following:

IN-PLAN ROTH ROLLOVER ACCOUNT	
IRR Contributions ($10,000 of which was nontaxable)	$100,000
Earnings on the IRR account	$ 6,000
Total IRR account balance	$106,000

ROTH DEFERRAL ACCOUNT	
IRR Contributions ($10,000 of which was nontaxable)	$ 80,000
Earnings on the IRR account	$ 24,000
Total IRR account balance	$104,000

TOTAL DESIGNATED ROTH ACCOUNT BALANCE AT THE TIME OF DISTRIBUTION	$210,000
Step 1: Determine the maximum amount available for an in-service distribution. (Pete hasn't reached a distributable event in his Roth deferral account.)	$106,000
Step 2: Determine the total earnings in the entire designated Roth account. ($6,000 in the IRR plus $24,000 in the Roth deferral account.)	$ 24,000
Step 3: Determine the total balance in the designated Roth account. ($106,000 in the IRR plus $104,000 in the Roth deferral account.)	$104,000

Step 4: Apply the pro-rata basis recovery calculation of §72 on the distribution amount of $106,000 to determine the taxable amount of the requested distribution as follows:
$106,000 (distribution) X $30,000 (total earnings)/$210,000 (total account balance) = $15,143 taxable amount of the $106,000 distribution

Step 5: Determine the return of basis allocable to the IRR account.
$106,000 (distribution) - $15,143 (taxable amount) = $90,857 return of basis from the IRR

Step 6: Pete determines the amount of the distribution subject to the 10 percent premature tax:

$ 90,000	taxable amount of his original IRR (due to income acceleration)
+15,143	taxable amount of the distribution based on the pro-rata recovery rules
$105,143	amount subject to the 10 percent premature tax
$ 10,514	amount of the premature tax reported on his 2010 Form 1040 (Pete may need to file Form 5329 with his tax return.)

At the time of the IRR, the $90,000 was exempt from the 10 percent premature tax. However, since he took a distribution from his IRR account before five years had lapsed, he's subject to the 10 percent recapture tax on his original taxable IRR. He also owes the 10 percent tax on the taxable amount of the distribution of $15,143.

Step 7: Pete determines the amount remaining of the original IRR, if any, that can be spread into his 2011 and 2012 gross income:

$90,000	original taxable IRR
($90,000)	accelerated into his 2010 gross income due to the distribution
$ 0	remaining for the two-year spread

Step 8: The $106,000 distribution is reported on a 2010 Form 1099-R by entering $106,000 in Box 1; $15,143 in Box 2a; $90,857 in Box 5; Code B in Box 7.

As set forth in the facts of this example, he also receives a 2010 Form 1099-R reporting the original IRR showing $100,000 Box 1; $90,000 Box 2a; $10,000 Box 5; Code G Box 7.

Pete must file a 2010 Form 8606 reporting the original IRR, the distribution, income acceleration, and the 10 percent recapture amount.

Step 9: After the $106,000 distribution, Pete still has $9,143 allocated to his IRR account because the $90,857 return of basis is allocated solely to the IRR account. For purposes of separate recordkeeping on Pete's Roth deferral account and his IRR account, his separate account balances now look like this immediately after the $106,000 distribution:

In-plan Roth Rollover Account		
	IRR remaining basis	$ 9,143
	Earnings on the IRR account	$ 0
	Total remaining IRR account balance	$ 9,143
Roth Deferral Account		
	Total Roth deferrals after the distribution	$ 80,000
	Earnings on the Roth deferral account	$ 14,857
	Total Roth deferral account balance	$ 94,857

TOTAL DESIGNATED ROTH ACCOUNT BALANCE AFTER THE DISTRIBUTION:	$104,000

If Pete takes the remaining $9,143 allocable to his IRR account, none of it will be taxable nor subject to the 10 percent recapture rule because the entire taxable amount of the IRR account was used up in the $106,000 distribution.

Is a beneficiary or alternate payee pursuant to a qualified domestic relations order (QDRO) eligible to elect an IRR?

A surviving spouse beneficiary or a spouse or former spouse alternate payee pursuant to a QDRO is eligible to elect an IRR in the same manner as the plan participant as specified in §402(c)(9) relating to a surviving spouse and §402(e)(1)(B) relating to a spouse or former spouse alternate payee pursuant to a QDRO. All of the rules that apply to the participant apply to the surviving spouse beneficiary or spouse or former spouse alternate payee pursuant to a QDRO. This is because IRRs can only be elected with an otherwise eligible rollover distribution as defined in §402(c)(4).

A non-spouse beneficiary isn't permitted to make a rollover, although §402(c)(11) permits a non-spouse beneficiary to elect a direct rollover to an inherited IRA, including a direct rollover conversion to an inherited Roth IRA.

Must a plan have a designated Roth contribution program 'in place' at the time an IRR is made?

Yes, in order for participants who make a 2010 IRR to use the two-year income spread, the distribution must be made no later than December 31, 2010, and, at the time of the IRR, the plan must have a designated Roth program in place.

Is a plan required to recordkeep Roth deferrals separately from in-plan Roth rollovers for each participant?

Yes, separate recordkeeping is necessary in order to properly allocate distributions to the IRR source for purposes of tracking the five-year recapture period and the income acceleration rule. As a third-party administrator, PenServ strongly suggests maintaining IRRs in a separate account or separately accounting for the portion of the total

designated Roth account allocable to Roth deferrals and the portion allocable to the IRRs.

Moreover, if the designated Roth account accepts incoming rollovers from another designated Roth account under another employer's plan, it would also be necessary to separately recordkeep these income rollover monies.

Why will waiting until 2013 to make an IRR (or converting to a Roth IRA in a qualified rollover contribution) affect an individual's taxation?

The Patient Protection and Affordable Care Act (PPACA) was enacted on March 23, 2010 and modified by the Health Care and Education Reconciliation Act of 2010. The provisions of the PPACA affecting retirement accounts include the following: Effective in 2013, the AGI threshold for determining deductible medical expenses is increasing from 7.5 percent of adjusted gross income (AGI) to 10 percent of AGI.

This change will affect a retirement plan participant who withdraws from a retirement account before age 59½. Premature retirement plan distributions are subject to an additional 10 percent income tax, unless the taxpayer meets an exception under Code §72(t). Thus, beginning in 2013, the 10 percent additional tax will apply unless unreimbursed medical expenses exceed 10 percent of the taxpayer's AGI.

Also effective in 2013, the PPACA imposes a 3.8 percent Medicare tax on the unearned income (interest, dividends, capital gains, annuities, royalties, rents, etc.) if the taxpayer's adjusted gross income for the year exceeds $200,000 ($250,000 for joint filers). The tax is determined based on the lesser of the amount of the unearned income or the amount in excess of the AGI limitation.

For example, Lucy is age 52 in 2013. She's unmarried and files a tax return as an individual. Her income sources in 2013 are:

Wages	$ 75,000
Unearned income (interest, dividends)	$ 50,000
Taxable conversion	$110,000
ADJUSTED GROSS INCOME	$225,000

Since Lucy's AGI exceeds $200,000, she's subject to a 3.8 percent Medicare tax on her unearned income amount of the lesser of the unearned income or the amount in excess of the AGI limit. Therefore Lucy is taxed on $25,000. This additional tax, in this example, equals $950 (3.8 percent X $25,000). This is in addition to normal income taxes due on her total taxable income for the year.

Do special rules apply if a taxpayer is using the two-year spread on 2010 conversions, but a distribution is made prior to including the entire taxable amount of the IRR in gross income?

Yes, this rule is referred to as the "income acceleration rule." If a participant receives a distribution in 2010 or 2011 allocable to the taxable amount of the 2010 IRR, the taxpayer's gross income for the year in which the distribution is made is increased by the amount of the distribution that was being deferred to 2011 and/or 2012. In this case, any remaining amount of the 2010 IRR to be included in 2012 gross income is reduced by the amount that was accelerated in an earlier year.

This income acceleration rule doesn't apply if the distribution is properly rolled over to another designated Roth account under an accepting employer's plan or to a Roth IRA owned by the participant. However, this income acceleration rule continues to apply to a subsequent distribution made in 2010 or 2011 from the plan that received the rollover. PC

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