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ROTH PROVISIONS IN THE SMALL BUSINESS JOBS ACT OF 2010

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In General

The "Small Business Jobs Act of 2010," which passed the Senate on September 16th, contains two provisions affecting Roth accounts within retirement plans. The first would permit Roth contributions to 457(b) plans maintained by State or local governments. This provision would be effective for taxable years beginning after December 31, 2010.

Second, the bill would permit amounts in 401(k), 403(b), and governmental 457(b) plans to be converted to Roth amounts within the plan, provided that only amounts that are distributable as an eligible rollover distribution may be converted. In addition, such conversions would only be permitted if the plan otherwise permits regular Roth contributions. The conversion amounts would be taxable, but would not be subject to the 10% early distribution tax under Code section 72(t). Also, in the case of 2010 conversions, the income generated by the conversion would be recognized over two years, starting in 2011, unless the individual elects for this income deferral provision not to apply. These conversion rules would apply to conversions after the date of enactment. Since Roth accounts are not permitted in governmental 457(b) plans until 2011, the 2010 conversion rules only apply to 401(k) and 403(b) plans.

Why Are These Provisions Being Proposed?

There are two reasons to permit Roth contributions to governmental 457(b) plans. First, very generally, 457(b) plans function as the State and local government version of a 401(k) plan; in this context, the bill would simply provide State and local governments and their employees with the same options available to the private sector through 401(k) plans. Second, the provision is a revenue raiser; it would raise $506 million over 10 years. The provision raises revenue because the individuals would include the amount contributed in income, unlike traditional 457(b) contributions.

There are also two reasons for the conversion rules. First, the provision raises $5.1 billion over 10 years, and thus is a very significant revenue raiser. The proposal raises money because in order to do a conversion, an individual needs to recognize income on the amount being converted. So plan savings that might not be included in income for many years would be included much earlier.

Second, a number of employer groups have expressed concerns about leakage out of 401(k) and 403(b) plans, as discussed below, unless conversions were permitted within plans.

Leakage concerns. Without the legislative proposal, the only way to convert non-Roth retirement plan savings into Roth savings is to roll the non-Roth plan savings into a Roth IRA, since rollovers from non-Roth plan savings to Roth accounts in plans are not permitted under current law. Prior to this year, taxpayers whose adjusted gross income exceeded $100,000 were not permitted to roll plan amounts or traditional IRA amounts into a Roth IRA. Effective in 2010, that prohibition was eliminated. For reasons discussed further below, such a conversion can be very advantageous in certain circumstances. This raises the possibility that many high-income participants would withdraw plan amounts to roll those amounts into Roth IRAs, thus giving rise to the leakage concerns expressed by some employer groups.

For example, most plans permit withdrawals after age 59 1/2, so individuals who have attained that age may want to withdraw assets to convert them. And in some plans, certain assets can be accessed prior to age 59 1/2. Please note in this regard that hardship distributions may not be converted. Only eligible rollover distributions are eligible for conversion, and hardship distributions are not eligible rollover distributions. However, some plans permit earlier non-hardship withdrawals of amounts not subject to the 401(k) withdrawal restrictions, such as matching contributions or nonelective contributions that are (1) not used in the ADP nondiscrimination test (or the ACP test in the case of nonelective contributions) and (2) not used in satisfying the applicable nondiscrimination safe harbors. For example, the law permits such amounts to be withdrawn (1) after the amounts have been in the plan for at least two years ("two-year rule"), and (2) by any individual with at least five years of participation. Some plans and plan service providers have expressed concerns that the desire to convert may trigger a run on plan assets during 2010.

There was another concern with respect to small business plans, though one that does not appear to have become a problem to the extent feared. There had been discussion that some small business owners who have not attained age 59 1/2 and want convert some or all of their plan assets may terminate their plan in order to withdraw the assets and convert them. As discussed further below, in some cases, it may make economic sense to do this, especially since a new plan can be established after the date that is 12 months after the assets of the terminated plan have been distributed. Reg. sec. 1.401(k)-1(d)(4)(i).

Reasons to convert from a traditional IRA to a Roth IRA in 2010. In the circumstances where it is advantageous, there are two very good reasons to do the conversion in 2010, as opposed to later years. This heightened the concerns of the employer groups, which were concerned about a very immediate leakage threat. One reason to do the conversion in 2010 is that current law contains a special rule, like the one in the legislation, under which the income generated by a conversion will, unless the individual elects otherwise, be recognized ratably over two years starting in 2011. So recognition of income is delayed. Another reason to do the conversion in 2010 is the possibility that income tax rates may be going up in 2011, at least for high-income taxpayers whose top marginal rate may increase from 35% to 39.6%. This point could cause many individuals to do a conversion in 2010 but to elect not to defer recognition of the conversion amount. (Whether it is advantageous to recognize income in 2010 or defer the income until 2011 and 2012 depends on numerous factors, including income tax rates and an individual's expected rate of return on investments.)

What did certain employer groups ask for to address the leakage issue? In general, as noted, certain employer groups expressed concern that the attractiveness of Roth conversions could result in assets being drained out of 401(k) plans. Those groups generally asked for three legislative changes. First, they asked for the ability to convert non-Roth amounts in a plan into a Roth account within the same plan. As described above, the proposed legislation would generally permit such conversions with respect to amounts that are distributable.

Second, certain employer groups asked that all amounts in a plan be permitted to be converted, not just distributable amounts. As noted, the legislation does not permit non-distributable amounts to be converted. This request reflected the concern described above that some small businesses may terminate their plans in order to take advantage of the 2010 opportunity to do a Roth conversion.

Third, some employer groups asked that the required minimum distribution ("RMD") rules applicable to Roth accounts in a plan be conformed to the RMD rules applicable to Roth IRAs. Roth IRAs are not subject to the pre-death RMD rules, so that distributions are not required to begin after age 70 ½; the RMD rules only apply to Roth IRAs after the IRA owner dies. Roth amounts in a plan, on the other hand, are subject to the regular plan RMD rules under which distributions may be required to begin after 70 ½ in many cases. The concern underlying this request was that if Roth IRAs remain advantageous (as compared to Roth amounts in a plan) by reason of favorable RMD treatment, there will still be an incentive to move assets from a plan to a Roth IRA. The legislation does not provide the requested change in the RMD rules. This may not be a material problem, however, for many plans. If a participant wants to take advantage of the Roth IRA RMD rules, the participant can roll the Roth assets from the plan to a Roth IRA later. There is no need to roll to a Roth IRA until the year before the later of (1) the year the individual attains age 70 1/2, or (2) in the case of an individual other than a 5% owner, the year of retirement. So, except for plans that want to keep assets under management post-retirement (and are willing to administer the RMD rules), the lack of favorable RMD treatment for in-plan Roth amounts may not be a problem.

What Does The Legislative Proposal Do?

Not much in a technical way. This is not meant facetiously or critically. Rather, it is simply meant to point out that, in general, anyone helped by the legislative proposal could easily convert from non-Roth to Roth in 2010 without the legislation. All the individual would need to do would be to take a distribution and then roll that distribution into a Roth IRA. So, subject to one clarification, the legislation does not allow Roth conversions for individuals who would otherwise not be able to convert. Instead, all that the legislation does is permit the converted assets to stay in the plan, instead of going to a Roth IRA. So why does the proposal raise $5.1 billion? Presumably, the proposal raises revenue because plans may make in-plan conversions so simple that many more participants will convert than would be the case if conversions required withdrawing assets from a plan and sending them to a Roth IRA.

There is, however, one situation where the proposal would clarify that certain conversions would be permitted. The bill's legislative history clarifies that a plan can be amended to provide additional distribution options but restrict those distribution options to Roth conversions. For example, assume that a 50-year old individual has participated in a plan for 10 years and has $75,000 attributable to elective deferrals and $50,000 attributable to matching contributions. The matching contributions are not subject to the 401(k) withdrawal restrictions, but nevertheless the plan applies those restrictions to the matching contributions. So the participant is not permitted to take any distributions and thus could not convert any amounts to Roth amounts. Under the proposal, the plan could be amended to permit some or all of the $50,000 to be distributed under present-law rules – such as the rule allowing distributions to participants with at least five years of participation. But such distributions could be limited to amounts that are converted to a Roth amount within the plan. So the plan could continue prohibiting the individual described above from taking an actual distribution, but could permit such distributions only for the purpose of converting to a Roth account within the plan.

The proposal applies to surviving spouses as well as to participants.

Why Are Conversions So Advantageous?

Fundamental advantage. The fundamental reason that conversions are advantageous is that the law permits the full pre-tax amount to be converted, not just the after-tax amount. An example illustrates this point. Assume, for example, that an individual's marginal tax rate is and will always be 40%. In that case, it is mathematically provable that for such an individual, having $100 in a traditional IRA is the economic equivalent of having $60 in a Roth IRA. (For convenience of presentation, this analysis does not take into account indirect tax effects, such as the effect of additional income on income-based "phase-outs", like the Code section 86 rules regarding the taxation of Social Security benefits.) So such an individual is indifferent as to whether she contributes $100 to a traditional IRA on a pre-tax basis or pays $40 of tax on that $100 and contributes the net amount of $60 to a Roth IRA.

So assume that the individual has $100 in a traditional IRA. If the individual were to withdraw that $100, pay her $40 of taxes out of the $100, and contribute the net $60 to a Roth IRA, she would be in the same economic position. However, the law permits her to do something much more advantageous. Instead of paying the $40 of taxes out of the withdrawn $100, she can pay the taxes out of her after-tax savings, so that she can convert the full $100 to a Roth IRA. Since having $100 in a traditional IRA is the economic equivalent of having $60 in a Roth IRA, this gives her the opportunity to effectively make a new contribution to a Roth IRA of $40.

So if we use a larger scale example, a high-income individual with $1 million in a traditional IRA and substantial after-tax savings may pay her $400,000 of taxes out of those after-tax savings, and thereby effectively make a $400,000 contribution to a Roth IRA. This is an extremely attractive opportunity.

This is not to say that there are not potential disadvantages to such a conversion. For example, it is possible that the law will be changed and Roth IRAs will become subject to some taxation, at least in the case of high-income taxpayers. That would certainly be a very unfair development in many ways, but the possibility cannot be dismissed. Also, the above analysis is based on a constant tax rate of 40%. If an individual converts too much, the individual might end up in a very low tax bracket during retirement. That would mean that the taxpayer would have paid 40% on all conversion amounts, some of which would have been subject to a much lower tax rate in retirement if not converted. In deciding how much to convert, one has to make a judgment regarding future tax rates and one’s taxable income in retirement. It may be appropriate to do some “tax diversification”, i.e., not converting the maximum so as to preserve some taxable income during retirement.

The bottom line is here is that in many situations, but not all, it is likely that converting at least a portion of one's pre-tax savings to Roth savings will be very advantageous.

Other advantages. As referenced above, another potential advantage is avoidance of numerous phase-outs based on income. A full exploration of the many income phase-outs in the law is beyond the scope of this paper, but there will be many situations where a conversion will enable an individual to avoid a disadvantageous income phase-out during retirement (while still remaining in a high enough tax bracket to make a Roth conversion advisable as discussed in the preceding section).

Other factors. Other issues, which are also beyond the scope of this paper, should be considered. For example, state income tax issues should be analyzed, especially if a participant may move to a state with a lower income tax (or no income tax) during retirement. Estate tax issues – state and/or federal – may be relevant. And a participant's health and longevity expectations are relevant. If a participant is not expected to live very long, the RMD advantage (discussed further below) is less significant and the expected tax brackets of the participant's beneficiaries should be taken into account in determining whether a conversion makes sense.

Advantages Applicable To Roth IRAs But Not To Roth Amounts In Plans.

The fundamental advantage of conversions described above would apply to conversions within a plan, as permitted by the Senate proposal. Also, the two alternative advantages of a 2010 conversion -- recognizing income before rates go up and the ability to elect to defer recognition of the conversion amount until 2011 and 2012 -- would also apply to conversions within a plan under the proposal.
But, as discussed below, certain favorable aspects of conversions to a Roth IRA would not apply to conversions within a plan. It should be noted, however, that the first two such aspects described below can, in many situations, be achieved with respect to plan conversions by rolling plan Roth amounts to a Roth IRA later.

This paper does not attempt to list all of the advantages and disadvantages of having assets in plans versus having assets in IRAs (such as the availability of loans under plans), but simply describes certain key issues with respect to the differences between Roth IRAs and Roth amounts in plans.

RMD rules. A key advantage of conversions to Roth IRAs (but not to Roth conversions within plans) is the RMD difference noted above. The RMD rules force pre-tax amounts out of plans and traditional IRAs before death, but the pre-death rules do not apply to Roth IRAs. This allows longer periods of tax deferral and thus significantly increases the potential tax advantages.

Basis ordering rules. Some individuals may be concerned about the effects of a large conversion on their after-tax savings (assuming that they pay the taxes on the conversion out of such savings). But the rules regarding taxation of Roth IRA withdrawals address this concern to some extent. In a Roth IRA, "qualified distributions" are, of course, non-taxable. (Qualified distributions are generally distributions that are made (1) after five years of participation and (2) (a) on or after age 59 1/2, (b) after death, (c) on account of disability, or (d) for first-time home purchases.) Moreover, nonqualified distributions are treated as basis first. Thus, an individual who is concerned that paying the tax attributable to the conversion out of after-tax savings will render him or her unable to pay expenses has a straightforward means of paying those expenses. In effect, those after-tax savings have simply moved to a Roth IRA and can be accessed without adverse tax effects.

The above approach does not work as well if the conversion is done within a plan. Withdrawals from a plan are generally treated as derived proportionately from pre-tax and after-tax amounts. For this purpose, only amounts in the Roth part of the account are taken into account. So assume that an individual has a total account in a plan of $100,000, consisting of $40,000 in the Roth account and $60,000 in pre-tax accounts. Assume further that 70% of the Roth account (i.e., $28,000) is allocable to a conversion and the remaining 30% consists of earnings on the converted amount.
Assume further that the individual takes a $10,000 nonqualified distribution from the Roth account six years after the conversion. The amount treated as taxable is 30% of the $10,000, i.e., $3,000. If the distribution, however, had been taken from a Roth IRA, all $10,000 would be nontaxable under the rules described above.

Please note, however, that the above approach -- using Roth IRA assets to pay for expenses -- may not work well during the five-year period starting with the year of conversion. Under Code section 408A(d)(3)(F), distributions made during this period from the Roth IRA are, to the extent allocable to the converted amounts, treated as includible in income for purposes of the 10% early distribution tax. Thus, if a high-income individual's only Roth IRA assets are attributable to conversions -- which will be the norm -- such individual's withdrawals during the five-year period will be subject to the 10% early distribution tax unless they fit within an exception (such as the individual having attained age 59 1/2).

Please note that this special early distribution tax rule would also apply to conversions within a plan under the proposed legislation. But it is unclear whether distributions from the Roth account during the five-year period would be attributable first to regular Roth contributions (as is the case with respect to Roth IRAs) or first to converted amounts.

Finally, additional basis-related issues may arise when only a part of a distribution is converted to a Roth account within a plan. A full examination of these issues is beyond the scope of this paper, because they relate to unclear issues under current law.

Revocation of conversion. In the case of a conversion to a Roth IRA, a special rule allows an individual to elect to effectively nullify the conversion by the due date for filing the individual’s tax return for the year in which the conversion occurs; thus, the amount would be treated as staying in the traditional IRA. The IRS has interpreted this rule to permit such elections to be made by October 15th of the year following the year of conversion. This nullification opportunity can be quite valuable. For example, if an individual converts $100,000 from a traditional IRA to a Roth IRA and then the market value of the Roth IRA assets drops to $80,000, the individual would be paying tax on

$20,000 that he or she no longer has. In that case, it may be very helpful to have the ability to revoke the conversion election.

As noted, this ability to nullify a conversion election exists in the case of a conversion to a Roth IRA. It does not exist in the case of a conversion within a plan under the Senate proposal. This is not an insignificant advantage to using a Roth IRA conversion.

Another interesting issue is whether the IRS will extend the October 15, 2011 deadline in the case of a 2010 conversion with respect to which the income is recognized in 2011 and 2012. The purpose of the October 15 deadline is to roughly coincide with the due date for the return that must reflect the income attributable to the conversion. Where no income is recognized until 2011, there is no reason to require the nullification election until October 15, 2012.

If The Proposal Is Enacted This Year, What Challenges Will Be Created?

It is very possible that the Senate's Roth provisions will be enacted sometime during September of 2010. If this occurs, it will pose administrative challenges for all parts of the retirement community.

Because of the favorable treatment of 2010 conversions, there would likely be immediate pressure to offer conversions within a plan. Thus, service providers would need to build administrative systems that permit such conversions. Service providers would also need to create explanatory materials for plan sponsors that would have to decide whether to permit such conversions. And there would also be a need for communication materials and tools that can be provided to participants who would have to make complicated and important decisions regarding conversions. Also, Form 1099-R reporting of the conversions would be required, presumably with a new coding system; preparation for this reporting obligation should begin as soon as guidance is issued in this regard.

Since the proposal only permits conversions of "eligible rollover distributions", conversions would not be subject to the optional withholding rules under Code section 3405. In addition, since conversions would appear to be direct rollovers, it appears, though not clearly, that mandatory 20% withholding would also not be required under section 3405 with respect to converted amounts. The statute exempts direct rollovers from 20% withholding, but the regulations imply that the excludability from income of direct rollovers is part of the justification for such exemption, which makes the issue unclear in the case of conversions. The exemption from 20% withholding of conversions from plans to Roth IRAs lends some support for a similar exemption in the case of in-plan conversions, but in light of the different statutory structure, this analogy is not conclusive.

Exempting conversions from withholding under section 3405 is not necessarily the right result for participants, who could encounter estimated tax issues, as noted below. But it is the same result that applies in the case of conversions from plans to Roth IRAs. Moreover, it would be difficult to apply a different rule for 2010.
How would the withholding rules apply to amounts that are distributed in 2010 but may not be includible until 2011 and 2012? It makes sense for such distributions to be exempt from withholding under section 3405, as was the case with respect to 1998 conversions from traditional IRAs to Roth IRAs. The income attributable to 1998 conversions to Roth IRAs was permitted to be spread over four years, so that the application of the withholding rules for 1998 would not have made sense. A similar situation exists today. One rationale for special treatment of 2010 is that, due to the ability of taxpayers to defer the recognition of the income attributable to the conversion, the converted amount may not be a "designated distribution" under section 3405 because it may be reasonable to believe that the amount is not includible in income in 2010.

In short, it appears, though not clearly, that plan conversions are exempt from withholding under section 3405, but immediate confirmation of this would be very helpful. Please see IRS Notice 2008-30 for references to the permissibility of voluntary withholding agreements in a similar situation, i.e., rollovers from plans to Roth IRAs.

The challenges for service providers, plans, and participants are further complicated by the immediate effective date and the corresponding lack of guidance on key issues, such as the withholding issue noted above. For example, it is unclear if the favorable treatment of net unrealized appreciation ("NUA") can apply to conversion distributions that otherwise qualify for such treatment, or if the favorable tax treatment of lump sum distributions made to participants born on or before January 1, 1936 can apply. Neither set of rules applies to rollovers from plans to Roth IRAs, but the statutory structure underlying rollovers to Roth IRAs is different, thus raising a question with respect to conversions within plans. On the other hand, the legislative history contains a general statement that the rules regarding including converted amounts in income are the "same … as if the distribution were rolled over to a Roth IRA." Also, applying the NUA rules to conversions would lead to a number of statutorily unaddressed questions regarding how the NUA would eventually be taxed, making it seem somewhat less likely that the IRS will conclude that any of these favorable rules apply to converted amounts. This issue also needs to be resolved quickly.

Another unclear issue relates to what constitutes a 2010 conversion. If a participant's election to convert is made by December 31, 2010, but the plan's records do not reflect the conversion until some time in 2011, has the conversion occurred in 2010 or 2011 for tax purposes? Without further guidance, it would appear that such a conversion occurs in 2011, which would put even more timing pressure on service providers. However, it would be very helpful if the IRS could provide transition relief treating such a conversion as occurring in 2010.

Other issues may arise as particular plan terms and issues are examined. For example, assume that a participant has a loan outstanding with respect to distributable amounts. The participant will likely want to convert the loan amount, which may require a change in plan terms and/or in plan administrative systems. And plans' withdrawal ordering rules may need to be reviewed; participants will likely want to convert after-tax amounts first. If the employer wants to change those ordering rules, that will require additional work by the service provider.

Plan sponsors will need to process the information provided by the service providers and make quick decisions regarding whether to allow conversions within plans. And plan sponsors will need to decide whether to facilitate such conversions by creating new distributable events within their plans (such as attaining five years of plan participation), and, if so, whether participants will just be able to do conversions with respect to such events or will also be able to take actual distributions. A plan's adoption of any such new distributable events will put further pressure on service providers to achieve significant changes in a very short amount of time.

Plan sponsors will also need to think carefully about how to structure the communication process with participants. As noted, the decision for participants is a complex and significant one, and it is hardly likely that written communications alone will suffice. Seminars, help lines, and on-line modeling tools will likely be needed.

Further complicating this issue for plan sponsors is the need to adopt basic Roth features in their plans if they do not already have such features. As noted, having a Roth feature in the plan is a requirement under the Senate proposal for conversions within plans to be permitted.

The legislative history indicates that it is intended that the IRS provide employers with a remedial amendment period that allows them a "sufficient" period of time to amend their plans to reflect this conversion option. Hopefully, the IRS will interpret this legislative history broadly to apply not only to amendments to permit conversions, but all other related amendments, such as amendments to establish a Roth feature, amendments permitting loans to be converted, amendments adopting new distributable events, etc. Thus, under the desired guidance, a plan could implement all of such Roth-related features in 2010 but wait until after 2010 to adopt the corresponding plan amendments.

Finally, as noted above, this will be a difficult issue for participants. Participants will need to understand the long-range tax advantages of conversions, make complex projections about their future tax brackets, decide on the optimum amount to convert, and evaluate the extent of their ability to use after-tax funds to pay the tax on the conversion. Participants will also need to be careful not to incur estimated tax penalties attributable to the increased tax obligation generated by the conversion. Although the participants eligible to convert under the proposal could, even without the proposal, do a Roth IRA conversion, the proposal will highlight this opportunity for many participants, thus “creating” the difficult decision.

The pressures with respect to governmental section 457(b) plans are slightly different. Because the new rules do not apply until 2011, there is no pressure to adopt Roth features or in-plan conversion features in 2010. But there may well be pressure to adopt both in 2011, which could require significant work for service providers and plan sponsors, especially since the 457 community has not been exposed to Roth features before.

Some service providers have already begun work on the above set of issues, in case the Senate proposal passes. Regardless, enactment this year would create some intense pressures on service providers, plans sponsors, and participants.