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Fiscal Cliff Act Expands In-Plan Roth Conversions

As a result of the newly enacted American Taxpayer Relief Act of 2012 (the "Act"), it is now easier for a plan participant in an applicable retirement plan (i.e., a tax-qualified 401(k) plan, 403(b) plan, or governmental 457 plan) that permits Roth contributions to transfer assets from a pre-tax account to an after-tax Roth account in the same plan. In general, Roth contributions are after-tax contributions with respect to which the participant pays no tax on any principal and may be eligible to pay no tax on investment gains when they are distributed.

A qualified Roth contribution program is any program under an applicable plan that allows a participant to designate certain contributions as after-tax Roth contributions that would otherwise be contributed on a pre-tax basis. A Roth contribution program is "qualified" only to the extent that the underlying plan: (i) creates a separate Roth account for each participant that is designated to receive Roth contributions; (ii) maintains separate recordkeeping for each Roth contributions account; and (iii) prohibits forfeitures or non-Roth contributions from being allocated to the Roth account.

Previously, a participant's pre-tax contribution could be converted into a Roth contribution only if the amount so distributed was an eligible rollover distribution, the plan allowed for in-plan Roth rollovers, and the distribution satisfied the rules of the Internal Revenue Code (the "Code") regarding the timing of the distribution. For example, under the prior Roth conversion rules, a conversion would not be permitted with respect to a 401(k) plan participant who had not incurred a severance of employment, reached age 59½, died, or suffered a disability.

As of January 1, 2013, however, any amount contributed to an individual account under an applicable plan may be converted to an after-tax Roth contribution, regardless of whether the sum converted satisfies the requirements of an eligible rollover distribution as defined by the Code, or the participant is otherwise eligible to receive a distribution from the plan. That is, pending future guidance from the IRS, it appears that as a result of the Act, a participant may effect a Roth conversion at any time, so long as the terms of the plan include a Roth conversion provision and permit Roth contributions. Thus, a plan is now permitted to allow in-plan Roth conversions not only of amounts electively deferred on a pre-tax basis by the participant, but also with respect to other amounts contributed to the plan. Consequently, amounts such as employer matching contributions, profit sharing contributions, employer nonelective contributions, and participant rollover contributions may be converted to after-tax amounts via an in-plan Roth conversion.

If you have any questions concerning the new Roth conversion rules or if you would like assistance in amending your plan to address Roth accounts, please contact us.

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This edition of the Employee Benefits & Executive Compensation Alert highlights new rules concerning Roth conversions. The Alert was written by Devin M. Karas, a member of the Employee Benefits & Pension Practice Area at Reid and Riege, P.C. The Practice Area works closely with clients to design and draft tax-qualified and nonqualified retirement plans. For information or additional copies of this Alert, or to be placed on our mailing list, please contact Devin (tel. 860-240-1063) (e-mail dkaras@rrlawpc.com) or another member of the Practice Area, John J. Jacobson, Chair (tel. 860-240-1006) (e-mail jjacobson@rrlawpc.com), John V. Galiette (tel. 860-240-1009) (e-mail jgaliette@rrlawpc.com), Ronald J. Koniuta (tel. 860-240-1034) (e-mail rkoniuta@rrlawpc.com), or Erek M. Sharp (tel. 860-240-1074) (e-mail esharp@rrlawpc.com), or the Reid and Riege attorney with whom you regularly work.

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