IN-PLAN CONVERSION TO DESIGNATED ROTH ACCOUNTS

Most contributions to 401(k) plans, are made on a pre-tax basis. In other words, the contributions are not treated as taxable income at the time the amounts are contributed. Instead, pre-tax contributions and investment gains are treated as ordinary (taxable) income when distributed.

401(k) Roth deferrals, on the other hand, are treated as taxable income when contributed, but distributions (including deferrals and investment earnings) are not generally treated as taxable income at distribution. Amounts held in pre-tax accounts may be converted to a Roth account—this is commonly known as an in-plan Roth conversion. Some features and requirements of in-plan Roth conversion are:

- In-plan Roth conversions are available without regard to Adjusted Gross Income.

- Whereas Roth contributions to a plan may only come in the form of a Roth 401(k) deferral (ie, a deferral of salary or wages), any pre-tax money source within a 401(k) plan (e.g., 401(k), profit sharing, safe harbor, matching, etc.) may generally be converted to a Roth money source. Keep in mind, however, that after an in-plan Roth conversion, the converted funds remain subject to any distribution restrictions that applied to the funds prior to the conversion.

- In prior years, only amounts in the plan that were "distributable as an eligible rollover distribution" could be converted. In practice, this generally meant that an account could not be converted until a participant reached retirement age or terminated employment. This restriction was lifted in 2013.

- Amounts converted to Roth funds are generally treated as ordinary income to the Participant *at the time of conversion*. A portion of the converted amount may distributed to the participant to cover the pending income taxes, but such a distribution is subject to the requirement that the amount must be otherwise distributable under the plan's terms.

- A plan must have terms that permit ongoing Roth 401(k) deferrals to allow in-plan Roth conversions.

- The plan must include terms (or be amended to add terms) that allow for in-plan conversions and the provisions must be communicated to all participants.

- Unlike Roth IRAs, Roth funds in a defined contribution plan remain subject to the Required Minimum Distribution rules for participants 70½ and older.

- If you withdraw funds converted to a Roth account within five years of conversion or prior to attaining age 59½, the investment earnings will be treated as ordinary income and a 10% penalty tax will apply. Rolling over funds to another plan (the receiving plan must include Roth provisions as well) or Roth IRA does not trigger the income recognition or penalty.

- Roth accounts must be accounted for separately from all pre-tax accounts.

If you are interested in learning more, please contact your IAI consultant or call 503.520.0848.

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