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October 13, 2010

George Bostick
Benefits Tax Counsel
Department of Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Andrew Zuckerman
Director, Rulings and Agreements, Employee Plans
Internal Revenue Service
1750 Pennsylvania Ave., NW
Washington, D.C. 20006

Re: In-plan Roth Conversions under Section 2112 of the Small Business Jobs Act of 2010
(P.L. 111-240)

Dear Messrs. Bostick and Zuckerman:

The Investment Company Institute requests guidance on section 2112 of the Small Business Jobs Act of 2010, which allows a distribution from a 401(k), 403(b), or governmental 457(b) plan from an account that is not a designated Roth account to be rolled over into a designated Roth account under the plan. Although the law describes this as a distribution and rollover, it is commonly referred to as an “in-plan Roth conversion.”

Because the law is effective immediately and participants who convert in 2010 receive special benefits (deferral of taxation until 2011 and 2012 in equal parts), Institute members providing services to employer plans will need to assist plans in making this opportunity available to participants as soon as possible. The ability of plans to take advantage of the law will be enhanced if the rules governing in-plan Roth conversions are understood and clear and plans and service providers know their withholding and reporting obligations.

Attached is a list of issues on which guidance is needed and a recommendation on how they can be addressed to facilitate adoption and use of in-plan Roth conversion features and reduce unnecessary administrative expenses. The most pressing issues are the first seven items on the list: **withholding, 1099-R reporting, recharacterization, the steps needed to complete an in-plan Roth conversion, plan amendment requirements, application of the five-year waiting period, and loans.**

Messrs. George Bostick and Andrew Zuckerman
October 13, 2010
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Please feel free to contact me (202-326-5810, mhadley@ici.org) or Mary Podesta (202-326-5826, podesta@ici.org) if you have any questions.

Sincerely,

A handwritten signature in black ink, appearing to read "Michael Hadley". The signature is fluid and cursive, with a prominent initial "M" and a long, sweeping tail.

Michael Hadley
Associate Counsel – Pension Regulation

Attachment

cc: J. Mark Iwry
Alan Tawshunsky

Investment Company Institute
In-Plan Roth Conversions - Recommendations for Guidance

Withholding

- **Issue:** Since an in-plan Roth conversion generates taxable income to the participant, is the plan required to apply the 20% mandatory withholding in section 3405(c)(1)(B)? This is important to resolve immediately because service providers are concerned about withholding liability.
- **Recommendation:** An in-plan Roth conversion is similar for tax purposes to an eligible rollover distribution directly rolled over to a Roth IRA. Similar to a direct rollover to a Roth IRA, per section 3405(c)(2), no withholding should be required.

Reporting on Form 1099-R

- **Issue:** The instructions to 2010 Form 1099-R do not address whether a plan must generate a Form 1099-R for an in-plan Roth conversion and, if one must be generated, do not address how to code the distribution. The law provides that the rules in section 408A(d)(3)(D), which require certain additional reporting, will apply to in-plan Roth conversions.
- **Recommendation:** If a Form 1099-R will be required for 2010 in-plan conversions, use the same code used for direct Roth rollovers (Code G).¹ In addition, because of the short amount of time plans and providers have to make programming changes, IRS should provide reporting relief for 2010. IRS provided relief in similar circumstances in Notice 2009-9 for reporting required minimum distributions for 2009.

Recharacterization

- **Issue:** Under section 408A(d)(6), conversions to Roth IRAs from qualified plans and from traditional IRAs may be recharacterized by the due date (including extensions) for filing the IRA owner's federal income tax return. In addition, a conversion that is recharacterized may be reconverted, but the taxpayer may not do so before the later of the beginning of the year following the year in which the amount was converted to a Roth IRA or the end of the 30-day period beginning on the day on which the IRA owner transfers the amount from the Roth IRA back to a traditional IRA by means of a recharacterization. (Treas. Reg. § 1.408A-5, Q&A 9(a)(1)). The new provisions for in-plan Roth conversions do not reference these rules.

¹ If IRS decides that withholding is required, a special problem is present for 2010 since withholding will occur in 2010 even though the taxable income is not generated in 2010 (unless the participant elects otherwise). See Treas. Reg. § 1.408A-6 Q&A-13.

- **Recommendation:** Our reading of section 402A, as amended, is that recharacterizations of in-plan Roth conversions are not allowed. If IRS disagrees, it should provide guidance on whether the restrictions on reconversion that apply to Roth IRAs apply.

Steps to Complete Conversion

- **Issue:** What steps must a plan take to complete an in-plan conversion? The statutory language suggests that a distribution and a separate rollover may be required. Plans and their service providers may struggle to complete all the steps before December 31, 2010.
- **Recommendation:** A plan should be able to complete an in-plan conversion in a manner that will not result in the actual liquidation and reinvestment of the converted amount, as long as the plan's records reflect the in-plan conversion.² This approach eliminates the risk of market movement during the period the converted amount is not invested. We also recommend that, at least for 2010, a participant may be deemed to have converted the amount if the participant makes an election to convert and the plan makes substantial steps documented in plan records towards completion of the conversion.

Guidance on Amendment Requirements

- **Issue:** Plans will need to be amended to add the in-plan Roth conversion feature. It is not feasible to have all plans amended to add this feature for 2010 by the end of 2010.
- **Recommendation:** First, IRS should provide a remedial amendment period for plan amendments that add an in-plan Roth conversion feature. This would be consistent with the Joint Committee on Taxation's Technical Explanation discussion of Congress' intent.³ This remedial amendment period with respect to 2010 plan years should end no earlier than December 31, 2011. We also recommend that this remedial amendment period apply if the plan needs to add a designated Roth contribution program. Second, IRS also should clarify that adoption of this feature will not jeopardize the pre-approved status of prototype and volume submitter plans. Finally, our members believe that publication of a model amendment as soon as possible would be helpful.

Application of Five-Year Period

- **Issue:** There are three issues related to the five-year period. First, it is not clear from the law whether, for purposes of qualified distributions, in-plan Roth conversions are subject to a

² In the short term, some recordkeepers may wish to process an in-plan Roth conversion like an ordinary distribution and rollover. This also should be allowed, but not required.

³ See Technical Explanation, page 43 ("It is intended that the IRS will provide employers with a remedial amendment period that allows the employers to offer this option to employees (and surviving spouses) for distributions during 2010 and then have sufficient time to amend the plan to reflect this feature.")

separate five-year holding period beginning when the in-plan Roth conversion occurs. Second, the law states that the rules in section 408A(d)(3)(F), which contain special rules for the application of the 10% penalty in section 72(t), apply to in-plan Roth conversions. This suggests that conversions must be tracked separately for purposes of the 10% penalty in section 72(t), but it is not clear whether the plan administrator must perform this tracking. Finally, in the case of a Roth IRA that includes both contributions and rollovers, section 408A(d)(4) creates ordering rules that apply to a distribution. The law does not explicitly incorporate these ordering rules.

- **Recommendation:** First, in the absence of explicit statutory direction, the best approach to the five-year holding period for determining whether a distribution is qualified is that the period begins on the date of a plan participant's first designated Roth contribution or in-plan Roth conversion; a separate date should not be required for the later contributions or conversions. Second, IRS should clarify the application of section 408A(d)(3)(F) to in-plan Roth conversions, whether *each* conversion must be tracked separately, and whether the plan administrator will be required to perform this tracking. Finally, IRS should clarify how distributions from designated Roth accounts containing both participant contributions and in-plan Roth conversions are ordered.⁴ We recommend that IRS take into account the complexity and additional costs plans and participants may face if each in-plan Roth conversion receives its own 5-year period.

Loans

- **Issue:** It is unclear how the in-plan Roth conversion would apply to the portion of an account that is subject to a plan loan. Most plans do not provide for the distribution of loans. On the other hand, plans may allow loans from designated Roth accounts. Treasury regulations require that loans from designated Roth accounts satisfy the repayment requirements of section 72(p)(2)(C) separately from loans from non-Roth accounts but that all loans are aggregated for purposes of the maximum loan amount in section 72(p)(2)(D).
- **Recommendation:** Our members have noted a number of administrative difficulties in dealing with an in-plan Roth conversion of a loan. A straightforward approach would be to apply whatever rules the plan applies to distributions and rollovers – if the plan does not allow distributions or rollovers of plan loans, then loans cannot be part of an in-plan Roth conversion. If IRS decides that a participant may convert the portion of his account that is subject to a plan loan, it needs to clarify how the participant calculates the taxable amount due. IRS also should clarify how the rules in section 72(p)(2)(C) will apply to converted loan.

⁴ Plans often have rules for ordering of distributions (for example the plan may require that rollover contributions be distributed first). We are only asking for guidance on what ordering rules apply for purposes of tax treatment.

Finally, IRS should clarify whether plan amendments to add an in-plan Roth conversion feature must address loans specifically.

Sources for In-plan Roth Conversion

- **Issue:** Nothing in the law appears to restrict in-plan Roth conversions to pre-tax elective deferrals.
- **Recommendation:** IRS should confirm that in-plan Roth conversions are allowed from all non-Roth amounts in the plan, including after-tax contributions, employer contributions, and rollover contributions.

Conversion of After-tax Amounts

- **Issue:** The law appears to allow conversion of non-Roth after-tax contributions. Since publication of the latest model 402(f) notice, there has been considerable confusion about how to treat a distribution and rollover from a plan holding both pre-tax and after-tax contributions. The model 402(f) notice suggests a different (and more taxpayer friendly) result if the rollover is done indirectly than if the rollover is done directly. The Institute and others have asked Treasury and IRS to reconsider the model 402(f) notice position.
- **Recommendation:** We recommend that the IRS clarify the rules for income inclusion for partial in-plan Roth conversions from accounts that include both pre-tax and non-Roth after-tax contributions. We recommend, however, that this be undertaken as part of a comprehensive look at the treatment of non-Roth after-tax contributions.

Employer Securities and Individuals Born Before 1936

- **Issue:** Distributions that include employer securities are eligible for favorable treatment under the net unrealized appreciation (NUA) rules and participants born on or before January 1, 1936 can use certain optional methods to calculate income on distributions. These rules turn in part on distributions being made in a “lump sum.” Notice 2009-75 provides that rollovers from a non-Roth account in an employer plan to a Roth IRA are taxed in the same manner as if the distribution had been rolled over to a non-Roth IRA that was the participant’s only non-Roth IRA and that non-Roth IRA had then been immediately converted to a Roth IRA. Thus, the special rules relating to NUA and to participants born on or before January 1, 1936 are not applicable. It is not clear whether this rule applies to in-plan Roth conversions.
- **Recommendation:** IRS should provide guidance on the application of the NUA rules to in-kind conversions of property that qualify for NUA treatment and on the application of the special tax rules for participants born on or before January 1, 1936. Since the law suggests that an in-plan Roth conversion is accomplished through a distribution and rollover, the IRS should clarify whether this affects subsequent lump sum distribution treatment.

Spousal Consent

- **Issue:** Defined contribution plans subject to section 417 must obtain spousal consent before making a distribution in a form other than the qualified joint and survivor annuity. Since the law describes the in-plan Roth conversion as a distribution and rollover, even though the funds are never really distributed, it is unclear whether the requirement to obtain spousal consent applies.
- **Recommendation:** IRS should clarify if plans subject to section 417 must obtain spousal consent before a participant can make an in-plan Roth conversion.

Conditioning Distribution on Conversion

- **Issue:** The Joint Committee on Taxation's Technical Explanation states that a plan may condition a distribution on a participant electing to have the distribution rolled over to a designated Roth account in the plan.⁵ We understand some concern has been expressed whether this plan provision would violate section 401(a)(31), which requires all plans to allow participants to receive eligible rollover distributions in the form of a direct rollover.
- **Recommendation:** IRS should confirm whether a plan may condition a distribution on a participant electing to have the distribution rolled over to a designated Roth account in the plan. We believe that employers that limit in-service distributions may wish to add the in-plan Roth conversion feature only if this restriction were allowed, to help ensure participants preserve assets for retirement.

Restricting Conversions to Current Employees

- **Issue:** Some plan sponsors may wish to restrict in-plan Roth conversions to active employees and not allow in-plan Roth conversions to spouses, beneficiaries or terminated employees.
- **Recommendation:** IRS should clarify whether plans may restrict in-plan Roth conversions to active employees. Generally a plan is allowed to limit the circumstances under which it will accept rollovers contributions. (Treas. Reg. § 1.401(a)(31)-1 Q&A-13.) Since terminated employees with a vested account always have the option of a direct rollover to a Roth IRA, it does not appear that this restriction would violate the "significant detriment" rule. (Treas. Reg. § 1.411(a)-11(c)(2)(i)).

⁵ See Technical Explanation, page 42-43 ("However, if an employer decides to expand its distribution options beyond those currently allowed under its plan, such as by adding in-service distributions or distributions prior to normal retirement age, in order to allow employees to make the rollover contributions permitted under this provision, the plan may condition eligibility for such a new distribution option on an employee's election to have the distribution directly rolled over to the designated Roth program within that plan.")