Kidder Benefits Consultants, Inc.

5700 Westown Parkway, Suite 100
West Des Moines, IA 50266
www.askkidder.com

phone 515.254.1178
toll free 800.300.3086

October 2010

National Edition
Volume 4 Issue 5

Consulting Offices:
Omaha, Nebraska
Albuquerque, New Mexico
Rochester, Minnesota

Regional Consulting and Administrative Office:
Tucson, Arizona

Ask Kidder.®

Roth Conversions in a 401(k) or 403(b) Plan: What are the issues that should be considered?

The Small Business Jobs Act of 2010 signed by President Obama on September 27, 2010 contained provisions allowing the conversion of your 401(k), 403(b) or 457(b) account into a "Roth" account within the plan. This law became effective on the signing date. To utilize the conversion option, the plan sponsor must amend the plan to allow conversions and permit regular Roth contributions (if not allowed already).

In a traditional 401(k) or 403(b) plan, contributions are made on a pre-tax basis, and the assets are subject to income tax on withdrawal. In other words, you get a tax deduction now, assets accumulate tax-deferred, and you pay income tax on funds as they're withdrawn.

The Roth feature allows elective contributions to be made after tax. The benefit is that assets withdrawn from the Roth account (after meeting certain requirements) are not subject to income tax. In the Roth environment, you pay your tax upfront, assets accumulate without tax, and when the funds are withdrawn, there is no income tax.

Converting existing assets from traditional to Roth creates an income tax event, now, to allow for tax free withdrawals later.

It is pay me now (Roth), or pay me later (traditional).

Comment: *As of October 19, 2010 and according to J. Mark Iwry of the U.S. Department of the Treasury, guidance on Roth conversions will be forthcoming very soon. The IRS recommends that sponsors wait for that guidance before moving forward with any "in plan" Roth conversions.*

The Roth feature has been in place for elective deferrals since 2006 for IRAs and plans that allowed inclusion of the Roth provision. However, the option to convert existing balances has not been available until now. Only assets considered as eligible rollover distributions may be converted. Hardship distributions are not considered eligible rollover distributions.

The use of Roth has been slowly expanding. The primary difficulty in providing the Roth feature has been the fact that electing to use it is an individual financial and tax planning issue. Determining whether to pay income taxes up-front or later is beyond the scope of the general enrollment or follow-up education provided by plan sponsors. The participants' own financial and tax professionals should be involved in the decision.

A. Why was this provision part of the 2010 Act?

1. Use of the Roth contribution feature is growing – especially among younger participants, so allowing for the conversion of existing "traditional" accounts is a natural progression of events.
2. There has been a concern that participants will use in-service withdrawals to remove funds from 401(k) and 403(b) plans and roll them over a Roth IRA. In 2010, the adjusted gross income limitation for a permitted rollover of a traditional account to a Roth IRA was eliminated. Since 401(k) and 403(b) plans are considered primary retirement accumulation vehicles, additional flexibility was provided to satisfy financial planning needs.
3. 457(b) plans (used by governmental and similar organizations) did not previously allow for Roth contributions. By passing this new law, 457(b) plans may allow for Roth conversions after 2010, so indirectly they must also allow for Roth elective contributions.
4. This is a BIG revenue raiser for the government. Allowing Roth conversions will produce an estimated $5+ billion of increased and accelerated revenue to the U.S. Treasury over the next10 years.

B. What is required to provide the Roth conversion feature?

A plan amendment must be prepared and adopted. (We will prepare this amendment for our clients.) Once completed, information about the amendment must be communicated to plan participants. (We can assist in this effort, as well.)

C. Can my Investment Platform Providers accommodate the Roth conversion?

While Kidder Benefits, as your third party administrator, can already accommodate this feature, some investment platform providers still need to update their systems. Before a decision is made, we will confirm if or when your Investment Platform Provider will be prepared to accommodate conversions.

Continued on Page 2

5700 Westown Parkway, Suite 100
West Des Moines, IA 50266
www.askkidder.com

phone 515.254.1178
toll free 800.300.3086
October 2010

National Edition
Volume 4 Issue 5

D. What does conversion mean, and what are the income tax consequences?

If an individual converts their account to Roth, the conversion amount is taxable income. It is not subject to the 10% early distribution tax. If the conversion is in 2010, the taxable income generated is recognized partly in 2011 and partly in 2012. The participant can also elect to have it taxed in 2010. If the conversion is in 2011 or later, there is no two-year option to spread income.

E. Where does the participant get the money to pay the income taxes?

The participant electing the in-plan conversion will receive a 1099-R with a special code. That 1099-R is used with their Form 1040 and will reduce their refund and/or increase their income taxes due to the Roth conversion. Any taxes due must be paid at the time the participant's personal tax return is filed. Participants who file estimated income taxes should work with their tax professionals to determine the impact to their estimated tax payments.

Since converted assets are inside the plan, they must look to assets and investments outside the plan (such as checking or brokerage accounts) to pay for additional income taxes.

Example 1: In 2011, a participant at age 59 1/2 (and eligible for a full in-service withdrawal) in a plan that allows in-service for all accounts at age 59 1/2, tells the plan sponsor, "I want to convert my entire $100,000 balance into Roth." $100,000 stays in the plan but is now marked "Roth" instead of "pre-tax." The participant's Form1099-R shows $100,000 of taxable income for the year. Income taxes on the conversion will be due on April 15, 2012, based on the participant's current income tax bracket.

Example 2: A participant (same as above) tells the plan sponsor "I want to convert $70,000 of my $100,000 balance into Roth, and I want to withdraw the rest as an in-service distribution and have it paid directly to me." The participant's Form 1099-R shows $100,000 of taxable income for the year. $70,000 stays in the plan and is now marked "Roth" instead of "pre-tax." Of the remaining $30,000, the participant is paid $24,000 and $6,000 is withheld for taxes. Depending on the participant's personal income tax situation and tax bracket, the $24,000 may help pay any additional income taxes owed.

Comment: *It is currently unclear whether or not the IRS will allow an "in-plan" conversion that also provides for a withdrawal of assets for tax payments.*

Keep in mind that withdrawing funds from an existing 401(k) account to pay the income taxes will add additional time for the remaining balance in the account to reach its pre-conversion value. Even more time will be needed to finally reach the tax savings breakeven point where the Roth amount with earnings exceeds the traditional amount with earnings.

F. What are the pros and cons of providing the Roth feature?

Pros:

1. For some individuals, the Roth may be a positive financial planning tool. Since the 401(k) or 403(b) is considered the main retirement vehicle for U.S. citizens, providing flexibility in plan provisions may allow them to contribute more to the plan.
2. In the right situation, converting a traditional account to Roth may provide a positive income tax outcome in the future. For example, if you choose to convert to Roth now, the converted amount will be taxed at current rates. If you believe your income taxes rates will be higher when you withdraw funds in the future, you may be better off converting now.
3. A key benefit of using Roth involves the time value of money. If you have a large number of years before you will withdraw the funds, then the compounding of the returns combined with the tax free withdrawal can mathematically prove more beneficial. Younger participants and especially higher earners may find the Roth feature and, potentially, the Roth conversion provision attractive for their longer term financial plans. Those with fewer years to recoup the income taxes paid today may find the Roth feature and conversion less attractive.

Cons:

1. Converting to a Roth is not free. You must pay income tax on the amounts converted. The amounts can be significant, even if they are paid over two years in the instance of a conversion in 2010.
2. Since income taxes must be paid, you must consider where the funds will come from to pay them. Depending on the conversion amount and your income tax bracket, the cash needed to pay the tax can be considerable.
3. Your income tax rates may be lower in the future than they are today, because your overall taxable income may be lower. In that case, it's possible to pay more in income taxes by converting to Roth.
4. Qualified plans require minimum distributions at age 70 ½, regardless of whether or not they have Roth provisions. In a Roth IRA, there are no minimum distribution requirements. This is not a big disadvantage, since participants will be of retirement age and eligible to roll their plan account over to a Roth IRA account.

Continued on Page 3

5. At retirement or withdrawal of assets from a traditional account, the participant has many tax planning techniques to delay and defer the payment of income taxes. These include rolling the assets to a traditional Rollover IRA and stretching out the distributions by taking only the minimum required amounts. With proper planning, it may be possible to stretch payments over the life of a surviving spouse and children, thereby maintaining the vast majority of the assets in a tax-advantaged and sheltered manner for many decades into the future. This may be more beneficial than paying the income taxes earlier for a tax free benefit later.

G. Final thoughts – Will Roth withdrawals remain tax-free?

A growing pool of Roth qualified plan and Roth IRA assets may be attractive to future Presidential and Congressional leaders to help pay for growing budget deficits. For participants, this is a 10-, 20- or 30-year financial and tax planning decision. Will the tax law remain the same 10, 20 or 30 years from now? Will our elected official say individuals over a certain income threshold will be subject to additional taxes or fees – and that distributions from retirement plans will be included in that calculation, even though the assets or income have been taxed previously?

1. Consider FICA. When paid, Social Security deductions are "after tax" contributions mandated and made by each and every wage earner. Originally, Social Security benefits were tax-free. But in 1983, the law was changed to include Social Security in calculating income on your 1040, then subjecting it to taxes if your income exceeded certain thresholds. In essence, double taxation on those amounts.
2. The Tax Reform Act of 1986 radically changed parts of the pension law. Some pension limits were retroactively reduced, creating a situation where certain types of Defined Benefit plans became instantly overfunded and could not be terminated without significant income tax consequences. Retroactive change to tax laws is possible.
3. Consider the new healthcare bill. If you make over $200,000 as an individual, or $250,000 as a joint filer, you will pay more in income taxes and increased Social Security taxes. You will also pay an additional tax on dividends and interest income. Singling out certain levels of income earners or those with certain assets has existed in our tax code for many years.

With every decision comes potential risk. Providing the Roth option will be beneficial to many, while it may not be the correct action for others. That is what makes the Roth contribution and conversion features more unique than many 401(k) and 403(b) features. They are longer term personal financial and tax planning decisions.

Plan sponsors and investment professionals must always take care to properly educate participants regarding available plan and investment options. However, in the case of the Roth features, plan sponsors must also be sure to direct participants to consult with their personal financial and tax professionals to determine if the Roth contribution and conversion options are right for them.

Have you visited our redesigned Ask Kidder website?

We recently made a number of user-friendly enhancements to our Kidder Benefit Consultants website, including one-click access to EFAST2 and Form 5500 submission tools, as well as a new Secure File Transfer to facilitate the exchange of confidential data and communications between Kidder and our clients. We are dedicated to providing services in a more secure and environmentally conscious manner. Please visit www.askkidder.com soon, and let us know what you think!

Behind the scenes: Technology and Security Enhancements

This summer, Kidder Benefits partnered with LightEdge Solutions to empower our company's IT department to run more efficiently and purposefully by gaining access to an enterprise-grade hosted environment and managed back-up and disaster recovery system. Kidder upgraded and co-located its array of servers to the LightEdge Data Center in Altoona, Iowa, which is a physically secure, enterprise-grade facility, housing a state-of-the-art private network architecture with inherent redundancies and failovers. This network is SAS-70 compliant, monitored 24/7/365 and maintained by certified systems engineers. Physical and electronic security features include redundant logs, mantrap doors, biometric authentication, video monitoring, secure racks and intrusion detection. Environmental controls include redundant air handling and HFC-125 Fire Protection, a primary non-ozone depleting agent. The facility also features multiple power grids, an uninterruptible power supply and available diesel generator. LightEdge operates a secondary data center that mirrors existing data in the event of a catastrophic failure of the primary facility.

This enhancement completes our circle of client data security when combined with the previous upgrade of our Document and Administrative/Compliance software and data to DMS and Relius ASP, part of the Sungard Company, which is a global leader in secure data management and disaster recovery.