Roth In-Plan Conversion Provisions of the Small Business Jobs Act of 2010 Come Up Short

By Allen Buckley

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The Small Business Jobs Act of 2010 (a bill), as recently passed by the U.S. Senate, comes up short with respect to allowing Roth conversions inside tax-qualified plans. The primary shortcoming is that only amounts eligible for distribution can be converted or rolled over to a Roth account, and elective deferral accounts are not distributable while a participant is working, unless the participant has attained age 59½ and the plan allows unlimited distribution of elective deferral accounts upon and after attainment of age 59½.

Specifically, section 2112 of the Small Business Jobs Act of 2010, as modified by Senate Amendment 4594 (a bill), provides with respect to any "distribution" to which new Internal Revenue Code section 402A(c)(4) applies, income inclusion applies as if the distribution was not part of a qualified rollover contribution, the ten percent penalty of Code section 72(t) does not apply and, unless the taxpayer elects otherwise, the amount required to be included in gross income for any taxable year beginning in 2010 will be included ratably over the 2-taxable-year period beginning with the first taxable year beginning in 2011. An election to include income in 2010 (instead of 50/50 in 2011 and 2012) cannot be changed after the due date of the taxpayer participant's return for the year.

In order for a distribution to be subject to the foregoing regime, the plan in issue must include a "qualified Roth contribution program," and the distribution must be rolled over to a designated Roth account in the individual's name. A qualified Roth contribution program means a Roth 401(k) feature. Accordingly, a pure profit sharing plan that did not include a 401(k) component would not be eligible. Also ineligible would be any other defined contribution plan that did not include a Roth 401(k) option. As noted in the Technical Explanation of the Bill (described below), a plan can add a Roth 401(k) feature to allow the distribution and rollover. (Practically, the distribution and rollover would simply be a taxable conversion within a plan not subject to the ten percent penalty.)

Generally, a profit sharing plan can permit a distribution upon the lapse of a fixed number of years. Revenue Ruling 71-295 provides that a fixed number of years means at least two years since the date of contribution. However, even though a 401(k) elective deferral option is a component of a profit sharing plan, this rule does not apply to 401(k) elective deferral accounts. Instead, as noted above, under Internal Revenue Code §401(k)(2)(B)(i), in-service distributions are generally impermissible with respect to 401(k) elective deferral accounts. Similarly, safe harbor matching contributions and safe harbor nonelective contribution accounts would not be distributable (and thus could not be converted to Roth accounts) because they are subject to the

same distribution rules as elective deferrals. Accordingly, a substantial percentage of accounts would be ineligible for conversion.

Why would the ability to convert be so limited? The Technical Explanation of the Tax Provisions in Senate Amendment 4594 to H.R. 5297, The Small Business Jobs Act of 2010, does not provide an explanation. In pertinent part, the Technical Explanation provides:

> Further, the distribution to be rolled over must be otherwise allowed under the plan. For example, an amount under a 401(k) plan subject to distributions restrictions cannot be rolled over to a designated Roth account under this provision. However, if the 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 on an employee's election to have the distribution directly rolled over to the designated Roth program within that plan.

It appears the drafters of the Technical Explanation may not understand that in-service distributions are generally not permitted with respect to 401(k) elective deferral accounts.

Finally, the Technical Explanation provides that it is intended that the IRS will provide employers a remedial amendment period to amend the plan after 2010 to reflect addition of a Roth option.

People who believe the current draft of the bill is deficient should contact their House of Representative member as soon as possible and request the House of Representatives address this defect as soon as possible.

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