

# 403(b)



# Perspectives

Insights into the Administration of §403(b) Tax-Sheltered Arrangements

FALL 2010

## In-plan Roth Conversion

**O**n September 27, 2010 President Obama signed The Small Business Jobs and Credit Act of 2010 (H.R. 5297) (SBJCA), which primarily provides tax cuts and better access to credit for small businesses. The bill also introduces a significant retirement plan provision, which, effective immediately, permits 403(b) plans to allow individuals (or surviving spouses) the ability to convert non-Roth accounts into designated Roth accounts within the plan (§2112).

### Designated Roth Permitted in Governmental 457(b) Plans

In addition, the law allows sponsors of governmental 457(b) plans to treat elective deferrals as designated Roth contributions by amending the definition of an "applicable retirement plan" under IRC §402A(e)(1) to include governmental 457(b) plans. The definition of "elective deferral" under §402A has also been amended to include amounts deferred under a governmental 457(b) plan. Governmental 457(b) plans may offer a designated Roth contribution feature for taxable years beginning after December 31, 2010. These plans also will be able to have in-plan Roth conversions.

### Background on Roth Conversion from Qualified Plans

Prior to the Pension Protection Act of 2006, if a participant wished to move money to a Roth IRA,

he or she had to first roll to a traditional IRA and then, if eligible, convert it into a Roth IRA. As of 2008, the Pension Protection Act permitted direct conversion of a qualified plan or 403(b) assets to a Roth IRA, eliminating the extra step (of first rolling it to a traditional IRA). However, for 2008 and 2009, a \$100,000 adjusted gross income (AGI) limit remained in effect, as well as a requirement for married taxpayers to file jointly.

As of January 1, 2010, the Tax Increase Prevention and Reconciliation Act of 2006 (TIPRA) eliminated the \$100,000 limit on AGI and the joint filing requirement. As a result, some high wage earners converted their qualified plan or 403(b) assets to a Roth IRA earlier this year. This caused concern over leakage of plan assets.

Congress has responded by allowing conversions within the plan to a designated Roth account. Thus, the new law will allow plans to retain more assets since conversion may be accomplished within a plan.

### Plan Eligibility

In-plan conversion is permitted only where the plan document contains, or is amended to provide, a designated Roth elective deferral feature. Thus, the conversion ability is available only

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in plans that may offer designated Roth accounts, specifically 401(k)s, 403(b)s, and (starting next year), governmental 457(b) plans. A plan sponsor cannot add the designated Roth account feature solely to allow for designated Roth rollover conversions.

## Distributable Event Required

As with a conversion to a Roth IRA, a distributable event is required before a conversion within the plan to a designated Roth account is permitted. Similarly, non-Roth accounts that convert to designated Roth accounts are treated as taxable rollover distributions from the non-Roth source to the designated Roth source (to the extent that the converted assets are pretax). The issuance of a Form 1099-R for the conversion amount is required. IRS guidance on the code to be used is needed, although it may be the same code used for the conversion to a Roth IRA (which is Code G).

## Withdrawal Restrictions Apply

*Based on existing restrictions on in-service withdrawals, what in-service distributable events may be utilized to convert within the plan to a designated Roth account?*

For elective deferrals, safe harbor contributions, QNECs and QMACs and all custodial arrangement employer contributions:

- In-service after the attainment of age 59½
- Note that hardship is not available because a hardship distribution is not an eligible rollover distribution

For employer NEC and Matching in an annuity contract (not in a custodial account before age 59½):

- The contribution has been in the plan for the 2 years in-service rule, or
- The 5 years of participation in-service rule

Rollover contributions:

- Provided the plan document permits in-service distribution of rollover contributions

Of course, a participant who separates from service has a distributable event for conversion purposes.

## Tax Consequences

Participants who roll over pretax accounts to designated Roth accounts in 2010 may elect to include the amount rolled over as income in 2010, or to include half the amount rolled in 2011 and half in 2012. In-plan conversions made after 2010 will be taxed in the year converted.

The 10% penalty on distributions under age 59½ is waived. However, there is a recapture tax on any distributions of converted funds that are made before five years has elapsed after the conversion.

Unlike Roth IRAs, there are no ordering rules for designated Roth account distributions. Thus, guidance is needed to address the tax treatment of a partial distribution from a designated Roth account that contains both conversion assets and annual designated Roth contributions for individuals under age 59½. Otherwise, the recapture tax cannot properly be calculated.

## Recharacterization to 401(k) Pretax Assets Not Permitted

"Recharacterization," which allows for a traditional IRA converted to a Roth IRA to be reverted back to a traditional IRA before the due date of a taxpayer's federal income tax return (including extensions), is not available for in-plan Roth rollover conversions. Specifically, a participant cannot reverse the conversion of assets to a designated Roth account back to pretax plan assets.

## Joint Committee on Taxation's Technical Explanation of the New Law Regarding Plan Amendments

There were issues addressed that would affect plan amendments; such as:

The Joint Committee on Taxation's technical explanation discussed (on page 42) the possibility of an in-service withdrawal provision being permitted under the rules above, but with the limitation of only being allowed for rollover to a designated Roth rather than an actual distribution.

The Joint Committee on Taxation's technical explanation of the SBJCA discussed the need for plan amendments and stated on page 43:

*"If a plan allows these rollover contributions to a designated Roth account, the plan must be amended to reflect this plan feature. 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.\*" <sup>\*\*</sup>See section 401(b), Treas. Reg. sec 1.401(b)-1, and Rev. Proc. 2007-44, 2007-2 CB 54, regarding remedial amendment periods for plan amendments."*

**Obviously, IRS guidance regarding the substance and deadline for adoption of an appropriate**

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amendment is needed. At the American Society of Pension Professionals and Actuaries Annual Conference in Washington, a senior Treasury Department representative made the statement that “employers should not make amendments

before guidance is issued or they may regret it.”

*As soon as more information is made available to the retirement plan industry, we will make it available to you. ■*

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## 403(b) Regulatory Definition of a “Year of Service”

**S**ection 1.403(b)-4(e) of the IRS’s final 403(b) regulations provides detailed rules for determining an employee’s years of service. A year of service is defined as each full year an individual is a full-time employee of an eligible employer, plus fractional credit for either part-time employees or full-time employees who only work part of a year. It is important that plan administrators be able to properly calculate “years of service.” Years of service are used to calculate each participant’s includible compensation, as well as limitations for catch-up contribution rules under Section 402(g)(7) and employer contribution allocations. An employee cannot accumulate more than one year of service in a twelve-month period. When computing the total years of service for an employee, each year must be figured individually and the sum of each of the individual years of service will determine his or her total years of service.

### Work Period

A year of service is based on an employer’s annual work period; the taxable year of an employee is not applicable. For example, a teacher’s annual work period is based on the academic year of the school instead of a calendar year. When an individual works for multiple employers, the only service considered for plan purposes will be the period worked for the eligible employer who sponsors the 403(b) plan. An exception to this rule exists for church plans.

### Special Rule for Church Employees

All periods of service between associated church-related organizations will be considered for determining years of service. Years of service for a self-employed minister will include both full and partial years in which he or she is employed by a tax-exempt organization that is a qualified employer.

### Measuring Work Performed

IRC §410(a)(3)(C) defines work performed based on an individual’s hours of service. The final 403(b)

regulations allow for work to be measured in days, weeks, months, or semesters based on appropriate facts and circumstances. It is common when dealing with educational institutions for an annual work period to span two calendar years.

### Full-time Employees

“Each annual work period during which an individual is employed full-time by the eligible employer constitutes one year of service. In determining whether an individual is employed full-time, the amount of work which he or she actually performs is compared with the amount of work that is normally required of individuals performing similar services from which substantially all of their annual compensation is derived.”

### Fractional Years of Service

A plan sponsor must determine fractional years of service whenever:

- A full-time employee performs service for only part of the annual work period;
- A part-time employee performs service for the entire annual work period; or
- A part-time employee performs service for part of the annual work period

### Examples:

The following examples are taken from IRS Publication 571 for the purpose of assisting plan sponsors with determining years of service:

**Full year of service.** If a doctor works for a hospital 12 months of a year except for a 1-month vacation, the doctor will be considered as employed for a full year if the other doctors at that hospital also work 11 months of the year with an additional 1-month of vacation. Similarly, if the usual annual work period at a university consists of the fall and spring semesters, an instructor at that university who teaches these semesters will be considered as working a full year.

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**Full-time for part of the year.** If, during a year, an employee was employed full-time for only part of the employer’s annual work period, the fractional period of service for that year is determined as follows:

- The numerator is the number of weeks, months, or semesters the individual was a full-time employee
- The denominator is the number of weeks, months, or semesters considered the normal annual work period for the position

For example, Jason was employed as a full-time instructor by a local college for the 4 months of the 2009 spring semester (February 2009 through May 2009). The annual work period for the college is 8 months (February through May and July through October). Given these facts, Jason was employed full-time for part of the annual work period and provided 1/2 of a year of service. Jason’s years of service computation for 2009 is as follows:

$$\frac{\text{\# of months Jason worked}}{\text{\# of months in annual work period}} = \frac{4}{8} = \frac{1}{2}$$

**Part-time for the full year.** If, during a year, an employee was employed part-time for the employer’s entire annual work period, the fractional period of service for that year is determined as follows:

- The numerator is the number of hours or days worked
- The denominator is the number of hours or days required of someone holding the same position who works full-time

For example, Vance teaches one course at a local medical school. He teaches 3 hours per week for two semesters. Other faculty members at the same school teach 9 hours per week for two semesters. The annual work period of the medical school is two semesters. An instructor teaching 9 hours a week for two semesters is considered a full-time employee. Given these facts, Vance has worked part-time for a full annual work period. Vance has completed 1/3 of a year of service, figured as shown below.

$$\frac{\text{\# of hours per week Vance worked}}{\text{\# of hours per week considered full-time}} = \frac{3}{9} = \frac{1}{3}$$

**Part-time for part of the year.** If, during any year, an employee was employed part-time for only

part of the employer’s annual work period, the fractional period of service for that year is determined by multiplying two fractions.

Figure the first fraction as though the individual had worked full-time for part of the annual work period. The fraction is as follows:

- The numerator is the number of weeks, months, or semesters the individual was a full-time employee
- The denominator is the number of weeks, months, or semesters considered the normal annual work period for the position

Figure the second fraction as though the individual had worked part-time for the entire annual work period. The fraction is as follows:

- The numerator is the number of hours or days worked
- The denominator is the number of hours or days required of someone holding the same position that works full-time

Then multiply the fractions together to determine the fraction representing the partial year of service for the year.

Maria, an attorney, teaches a course for one semester at a law school. She teaches 3 hours per week. The annual work period for teachers at the school is two semesters. All full-time instructors at the school are required to teach 12 hours per week. Based on these facts, Maria is employed part-time for part of the annual work period. Her year of service for this year is determined by multiplying two fractions. Her computation is as follows:

*Maria’s first fraction*

$$\frac{\text{\# of semesters Maria worked}}{\text{\# of semesters in annual work period}} = \frac{1}{2}$$

*Maria’s second fraction*

$$\frac{\text{\# of hours per week Maria worked}}{\text{\# of hours per week considered full-time}} = \frac{3}{12} = \frac{1}{4}$$

Maria would multiply these fractions to obtain the fractional year of service:

$$\frac{1}{2} \times \frac{1}{4} = \frac{1}{8}$$

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