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New Guidance on Roth Rollovers

Earlier this month, the IRS issued new guidance on rolling over distributions from qualified retirement plans into Roth IRAs. Though rollovers into Roth IRAs have been available since 2008, there will be some unique tax-planning opportunities in 2010.

Background. Contributions to traditional IRAs are typically tax deductible, and earnings accumulate on a tax-deferred basis. However, all distributions from a traditional IRA are taxable. In many ways, a Roth IRA works in reverse. Contributions are not deductible, but "qualified distributions" are not taxable. This means that rather than being tax-deferred, earnings on a Roth IRA are never taxed. (Note that a "qualified distribution" is one that meets certain age and other requirements to be received tax-free.)

Prior to 2008, one-step rollovers from qualified plans into Roth IRAs were not permitted (except from separate Roth 401(k) accounts). If a participant or beneficiary wanted to move a qualified plan benefit into a Roth IRA, the individual had to first roll over the qualified plan benefit into a traditional IRA and then convert that traditional IRA into a Roth IRA. The Pension Protection Act of 2006 eliminated the need for this two-step process by permitting direct rollovers from qualified plans into Roth IRAs.

New Guidance. The recent guidance from the IRS clarifies the income tax consequences of these types of rollovers as well as for rollovers from separate Roth 401(k) accounts into Roth IRAs.

- ***Non-Roth to Roth.*** If a participant or beneficiary elects to roll over non-Roth amounts in a qualified plan into a Roth IRA, the rollover amount (minus the amount of any after-tax contributions that were included in the rollover) will be taxable as ordinary income but will not be subject to the 10% tax on early distributions.

- ***Roth to Roth.*** If a participant or beneficiary elects to roll over a Roth 401(k) account into a Roth IRA, the rollover is taxed like a traditional rollover. Specifically, the amount of the rollover is not taxed nor is it subject to the 10% tax on early distributions. This applies even if the distribution from the Roth 401(k) account would not be a qualified distribution.

DOL Approves Summary Prospectus

If a retirement plan allows participants to direct the investment of their accounts, the fiduciaries of the plan can be relieved of some of their investment responsibilities if the plan complies with Section 404(c) of ERISA ("Section 404(c)"). Among other requirements, Section 404(c) requires plan sponsors to provide participants with specific disclosures about the plan's investment funds.

In the past, it has been necessary for plan fiduciaries to provide participants with either a full prospectus for the mutual funds they select or a more condensed mutual fund "profile" document. Earlier this year, the U.S. Securities and Exchange Commission, recognizing that very few funds were using profiles, replaced the profile document with the summary prospectus.

On September 8, 2010, the Department of Labor announced that Section 404(c) can be satisfied if participants are provided with a summary prospectus. Going forward, the ability of plan fiduciaries to deliver a summary prospectus in place of a full prospectus should simplify and facilitate compliance with Section 404(c).

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Restrictions on Roth Rollovers. There are no restrictions on "Roth to Roth" rollovers. However, currently, individuals with modified adjusted gross income of $100,000 or more and individuals who are married filing separate returns are prohibited from making "non-Roth to Roth" rollovers. Starting in 2010, both the income limit and the marital status restrictions will no longer apply, and all individuals will be eligible to make rollovers from non-Roth qualified plan accounts into Roth IRAs.

This may create a significant tax-planning opportunity for individuals who will be eligible to receive distributions from their qualified retirement plans in 2010. Some plan sponsors may consider adding or expanding the in-service withdrawal features in their plans to accommodate currently employed participants who want to take advantage of this opportunity.

Contact Information. For additional information about Roth rollovers, please contact Toby Walls (404.888.8870), David Putnal (404.888.8836) or Brian Coursey (404.888.8842).