In-Plan 401(k) Roth Conversions

Take-Away: Many qualified plan sponsors are now adding a Roth 401(k) feature to their basic 401(k) plan. That feature makes it easier for a younger plan participant to convert their basic 401(k) account to a Roth 401(k) account and enjoy tax-free earnings on that account. Despite the benefits of such an in-plan conversion, there are a couple of drawbacks that need to be considered before an in-plan Roth 401(k) conversion takes place.

Background: By this time, we all know the benefits of a Roth IRA, or a Roth 401(k) account. A fair reading of the SECURE Act 2.0 suggests that those in Congress would like to see more folks hold Roth retirement accounts, not so much because of their benevolence but because of the immediacy of income tax revenues resulting from a Roth contribution or a Roth conversion. One of the 'Roth problems' is that the Tax Code does not allow pre-tax deferred contributions to be withdrawn from a 401(k) account before the participant's age 59 ½ while the employee is still working. Additionally, many 401(k) plans also use the same age restriction regarding the employer's contribution to the 401(k) plan. Accordingly, it is impossible for that working employee who contributes to a 401(k) plan to convert his/her contributions to a Roth IRA before they attain the age 59 ½. Faced with these distribution and penalty hurdles, it may be possible for a 'younger' plan participant to make an 'in-plan' conversion of some or all their 401(k) account to a Roth 401(k) account. Of course, the 'devil is in the details.'

In-Plan Roth Conversion: An in-plan Roth 401(k) conversion is a transfer from any non-Roth account, e.g., a 401(k) account, to a Roth 401(k) account *within the same plan.* The transfer can include a participant's elective deferral accounts, the employer's contribution to the accounts, after-tax participant contributions to the accounts, and rollover accounts. Now for the details of an in-plan conversion to a Roth 401(k) account-

There Must be a Plan Option: Even when the plan sponsor authorizes the funding of a Roth 401(k) account inside the plan, the same plan does not have to offer an in-plan conversion. That is a choice the plan sponsor makes. If the option is not in the plan, then the in-plan conversion is not available.

No Age Restrictions: The transfer/in-plan Roth 401(k) conversion can be done at any age by the participant.

Direct Transfer: The in-plan Roth 401(k) conversion is accomplished by a direct transfer from the participant's traditional 401(k) account to the participant's Roth 401(k) account, implemented by the plan administrator. There are no 60-day rollovers to accomplish this in-plan transfer.

No Dollar Limit: There is no limit on the amount that can be transferred to the Roth 401(k) account with the conversion. However, the qualified plan can expressly limit the frequency of in-plan conversions made by the participant to minimize the administrative burdens associated with implementing an in-plan transfer.

Vested Balance: When in-plan Roth conversions were first permitted under the Tax Code, only those funds that the participant could withdraw from the plan *at that time* could be converted to the Roth 401(k) account. With changes to the Tax Code in 2013 any *vested* non-Roth funds can be converted to a Roth 401(k) account, regardless of whether the funds can be withdrawn from the qualified plan at that time or not.

Tax Consequences: With the in-plan Roth 401(k) conversion, the taxable portion of the conversion is included in the participant's gross income in the year that the conversion takes place. But just like with a Roth IRA conversion, once the Roth 401(k)conversion occurs, it is irrevocable, i.e., it cannot be 'recharacterized.'

No Withholding: All which translates to a plan participant should not consider an in-plan conversion to a Roth 401(k) account unless he/she has sufficient funds available to pay the increased income tax liability. With the direct rollover to the Roth 401(k) account, there is no required withholding, which means that the participant will then have to adjust their withholding on other taxable income or increase their estimated income tax payments to avoid any underpayment penalty with the larger tax bill.

Loans: In an interesting twist, while a Roth IRA owner cannot *borrow* from his/her Roth IRA, a Roth 401(k) plan may permit loans to be taken from the Roth 401(k) account by its participant.

Withdrawals: In another twist, the IRS allows a Roth 401(k) plan to offer in-service participant withdrawals of after-tax (i.e., non-Roth) contributed dollars before attaining age 59½. This means that while a normal after-tax contribution cannot be taken from the 401(k) plan by the participant prior to age 59 ½, a conversion of their after-tax contributed funds to the Roth 401(k) account can be taken by the participant at any time. This 'exception' might be exploited by a highly paid employee who could convert large amounts because after-tax contributions are not subject to the elective deferral dollar limits, e.g., $30,000 for those over the age of 50.

Net Unrealized Appreciation: Another drawback to an in-plan Roth 401(k) conversion is if the participant holds appreciated company (sponsor) stock in their 401(k) account and the participant wants to exploit the *net unrealized appreciation* (NUA) capital gain tax avoidance opportunity. When dealing with NUA there must first be a 'triggering event', which is usually when the participant turns age 59 ½, after which the *entire* 401(k) account must be distributed *within the same calendar year or with a subsequent calendar year, all in one lump sum.* If the 401(k) participant does an in-plan conversion after a 'triggering event' but he/she does not take out the rest of their account balance in the same calendar year, the lump sum distribution condition is not met. More to the point, if the sponsor-stock held in the traditional 401(k) account is transferred to a Roth 401(k) account as part of an in-plan conversion, the NUA tax break will no longer be available for those 'converted' shares; instead, the taxable amount of the conversion will equal the fair market value of the sponsor-stock on the day of the conversion- transaction, including all appreciation in the sponsor-stock. In sum, if there exists the NUA opportunity, probably an in-plan conversion is probably not a good idea.

5-Year 'Trap:' This trap can arise when in-plan conversion assets are distributed from the Roth 401(k) account. There is no 10% early distribution excise tax when an in-plan conversion is completed, However, that penalty can apply if taxable funds are converted to a Roth 401(k) account and the funds are distributed to the participant from the Roth 401(k) account before he/she attains the age 59 ½. That is if the distribution occurs within 5 years of the conversion, or technically within 5 years from January 1 of the year of the conversion. This can occur even when the distribution of the in-plan converted Roth 401(k) funds is never taxable. This is often referred to as the *5-year recapture rule.* The participant can also stumble onto this rule when the participant rolls the Roth 401(k) funds over to a Roth IRA. The 5-year recapture rule counts the period that the converted funds were held in the 401(k), which is different from the 5-year rule for distributions of tax-free earnings after the Roth 401(k) assets are rolled over by the participant to his/her Roth IRA- the Roth IRA 5-year rule takes precedence, which means that the time the assets were held in the Roth 401(k) account is *not counted* to satisfy the 5-year Roth holding requirement.

Example: In 2022 Cindy, age 45, makes an in-plan conversion of $100,000 from her pre-tax 401(k) account to her Roth 401(k) account. In 2026 Cindy leaves her employment and she rolls over $125,000 to her Roth IRA [$100,000 conversion amount in 2022 + $25,000 of earnings on the Roth 401(k) account from 2022 to 2026 = $125,000.] On December 31, 2026, Cindy takes a $30,000 withdrawal from her Roth IRA. With the 'normal' Roth distribution ordering rules, Cindy will be able to withdraw the entire $30,000 tax-free since the initial withdrawal will be treated as a non-taxable return of her funds from the in-plan conversion. However, Cindy's withdrawal will still be subject to the 10% recapture penalty, because Cindy is under age 59 ½ at the time of her withdrawal from her Roth IRA and it has been less than 5 years since January 1, 2022, the year of Cindy's in-plan conversion.

Conclusion: There are obvious tax benefits with an in-plan conversion of a traditional 401(k) account to a Roth 401(k) account. Who does not like tax-free earnings when in retirement. Yet balanced against those tax benefits are: (i) the conversion is irrevocable; (ii) the participant has to have separate funds to pay the accelerated income tax liability on the conversion; (iii) the in-plan conversion is not a good move if the 401(k) account holds sponsor-stock and it poses a jeopardy to the NUA tax deferral opportunity, and (v) then there is always the *5-year recapture penalty* to worry about. In short, there is plenty to think about before considering an in-plan Roth conversion.

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