



## CASE OF THE WEEK

### Can a 401(k) plan participant with an after-tax contribution account convert those assets to a Roth IRA?

Our ERISA consultants on the Columbia Management Learning Center Resource Desk regularly receive calls from financial advisors on a broad array of technical topics related to IRAs and qualified retirement plans. For example, through our relationship with the Columbia Management Learning Center, we routinely guide Columbia Management's financial advisor partners through the IRS rules and regulations that govern the conversion of qualified plan assets to Roth IRAs.

A recent call with a UBS advisor in Colorado is representative of a common scenario involving a 401(k) plan participant who is interested in directly converting his 401(k) after-tax account to a Roth IRA. The advisor asked: **Can my client, who is still working, convert his after-tax contributions in his 401(k) plan to a Roth IRA and, if so, what would be the tax consequences?**

#### Highlights of Recommendations

- Beginning in 2008 and for later tax years, qualified plan participants may directly convert qualified plan assets to Roth IRAs (Pension Protection Act of 2006 and IRS Notice 2008-30). (Prior to this, a plan participant was first required to roll over the assets to a traditional IRA and then convert the traditional IRA to a Roth IRA.)
- The income restriction for conversion eligibility was eliminated in 2010 and for future years pursuant to the Tax Increase Prevention and Reconciliation Act of 2005. As a result, any individual with convertible assets may follow the standard rules to complete a conversion to a Roth IRA.
- Whether a plan participant may take a distribution of plan assets while working is dependent upon the terms of his or her respective plan. Generally speaking, nearly 70 percent of all 401(k) plans today are written in such a way so as to allow participants to take in-service distributions.<sup>1</sup>
- Similarly, the ability of a plan participant to set aside a portion of his or her salary on an after-tax basis is plan dependent. Fifty-four percent of 401(k) plans allow participants to make after-tax contributions.<sup>2</sup>
- If the plan document so permits, it may be possible for a plan participant who is still working to request an in-service distribution of his or her 401(k) after-tax account balance.

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<sup>1</sup> 52<sup>nd</sup> Annual Survey of Profit Sharing and 401(k) Plans, Profit Sharing/401(k) Council of America, 2009

<sup>2</sup> 2009 Hewitt Universe Benchmarks—How Well Are Employees Saving and Investing in 401(k) Plans?, Hewitt Associates, May 12, 2009

- The Retirement Learning Center maintains a library of retirement plan documents for employers from across the country, and prepares plan “snapshot” summaries that include key plan features (e.g., the availability of in-service distributions and after-tax contributions). Financial advisors may gain access to the plan document library by working with their Columbia Management wholesaler.
- After-tax contributions can be targeted specifically for conversion purposes if 1) the terms of the plan permit it, and 2) the record keeper has maintained a separate account for the after-tax contributions and their earnings (IRS Notice 87-13).
- Pre-1987 after-tax contributions potentially can be recovered and converted without associated earnings (and, therefore, without tax) if the record keeper has tracked these dollars.
- Post-1986 after-tax contributions and earnings are subject to special “basis recovery rules” that require the participant to treat recovered amounts as consisting of a pro rata share of after-tax contributions and earnings (Notice 87-13). Any recovery of earnings is a taxable distribution.
- The Columbia Management Learning Center has a one-page, client-approved “Fast Fact” entitled, *Jump-Start Your Roth IRA with A 401(k) After-Tax Conversion* that advisors have found very helpful in explaining this concept to clients.

### Conclusion

The ability of a plan participant to complete a conversion of his or her 401(k) after-tax contribution account to a Roth IRA while working is highly dependent on the provisions of the plan document. If permitted, the taxability of the conversion depends on 1) whether the plan’s record keeper has separately accounted for the after-tax contributions and earnings; 2) the source of after-tax contributions by date (i.e., whether pre-1987 or post-1986); and 3) for the post-1986 amounts, the ratio of after-tax contributions to earnings. While the decision to conduct a conversion should be made by the client and his tax advisor, working with the employer, financial advisors who can demonstrate their knowledge of the conversion of 401(k) after-tax contributions to Roth IRAs set themselves apart from the average advisor and, thereby, win more rollover/conversion business. As always, the Columbia Management Learning Center is ready to help.