Executive summary. The American Taxpayer Relief Act of 2012 (ATRA), signed into law on January 2, 2013, expands the provision for in-plan conversions of pre-tax and after-tax money to Roth in certain defined contribution plans. The new law took effect for Roth conversions made after December 31, 2012.

The Small Business Jobs Act (SBJA) of 2010 allowed 401(k), 403(b), and governmental 457 plans offering Roth contributions to permit conversion of traditional pre-tax and after-tax money to Roth. However, to complete an in-plan conversion, the participant must have had a distributable event from the plan, such as termination from employment or an in-service withdrawal (for example, age 59½ withdrawals, withdrawal of rollover assets or after-tax contributions, or withdrawal of profit-sharing money). Also, only eligible rollover distributions could be converted (hardship withdrawals and required minimum distributions, for example, could not).

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ATRA expands the Roth in-plan conversion rules to allow for conversion of any pre-tax and after-tax money, regardless of whether the amounts are currently distributable, as long as the plan (1) permits regular Roth contributions and (2) adopts ATRA’s optional conversion provision.

In addition, in 2010, income limitations on eligibility for converting to a Roth IRA were lifted under the 2005 Tax Increase Prevention and Reconciliation Act (TIPRA), essentially allowing Roth IRA conversions by high-income earners who were previously excluded from doing so.

This paper provides detailed considerations and trade-offs between conversion within a retirement plan and Roth IRA conversion. Rather than make a general recommendation here, however, we emphasize that a Roth in-plan conversion decision will vary based on individual preference and a plan’s investment offerings. As always, we encourage anyone considering a conversion to first consult a tax advisor.

The retirement plan industry continues to see steady growth in the rates at which investors are adopting Roth accounts. This trend has happened both because the Pension Protection Act of 2006 made the provision for the Roth feature in retirement plans permanent, and because investors are increasingly understanding the tax-diversification benefits of the Roth feature. If a qualified plan offers Roth contributions—as plans are increasingly doing—participants have the flexibility to direct all or part of their contributions to Roth within the plan or to a traditional deferred account. In addition, some plans may offer participants the option to convert their pre-tax deferrals, employer contributions, and traditional after-tax deferrals to a Roth account. This Roth in-plan conversion option is more complicated than the contributory option, primarily because of the income taxes that a conversion would trigger. This paper provides an overview of recent legislative changes regarding in-plan conversions and discusses the trade-offs that participants will want to consider before deciding whether conversion makes sense for them.

Notes on risk: All investments are subject to risk, including possible loss of principal. Withdrawals from a Roth 401(k) are tax-free if you are over age 59½ and have held the account for at least five years. If you take a withdrawal from your Roth 401(k) account before age 59½ and less than five years from the first contribution, the portion of the withdrawal that is attributable to earnings would generally be subject to ordinary income tax and a 10% federal penalty tax. Withdrawals from a Roth IRA are generally tax-free if you are over age 59½ and have held the account for at least five years; withdrawals taken prior to age 59½ or five years may be subject to ordinary income tax or a 10% early withdrawal tax, or both.
To Roth or not to Roth?
Deciding whether to convert to a Roth can be a complex and highly personal decision. Bruno and Jaconetti (2011) provide a detailed discussion of the pros and cons. For the purposes of this discussion, however, these are some general guidelines:

- **Future tax-rate expectations**: Generally, if an investor anticipates being in a similar or higher future tax bracket when making withdrawals, a Roth may be advantageous. Because future tax-rate policies are uncertain, investors stand to benefit by investing in both pre-tax and Roth accounts as a hedge, thus using a tax-diversification strategy. Holding different account types is likely to provide the most flexibility for tax-efficient withdrawals in the future.

- **Availability of nonretirement assets to pay any income tax on conversion**: In most cases, the benefit of a Roth conversion may be maximized by using nonretirement assets to pay any resulting income taxes. Also, if the investor is under age 59½, any proceeds withheld for taxes would most likely be subject to additional taxes.

- **Effect of the conversion on the investor’s current marginal income tax rate**: Because the amount of the pre-tax assets being converted will be added to gross income, the conversion could push the investor into a higher marginal tax bracket in the year of conversion. In these situations, a partial conversion, or several partial conversions over multiple years, may ease the tax burden.

- **Required minimum distributions (RMDs)**: Unlike the case for traditional IRAs, Roth IRA holders are not subject to RMDs beginning at age 70½.²

- **Holding-period requirements**: Generally, Roth conversion money must be held for at least five years to avoid taxes. The longer the account remains untouched, the greater the potential for extended tax-free growth.

In-plan conversion to a Roth versus direct rollover to a Roth IRA
The most recent legislation affecting in-plan Roth conversions is the American Taxpayer Relief Act of 2012 (ATRA), which was signed into law on January 2, 2013. Its basic provisions as they pertain to in-plan conversions include:

- Only plans that permit Roth deferrals may offer in-plan conversions.

- For plans with a Roth feature, offering in-plan conversions is optional. To offer them, however, plans must be amended.

- The taxable portion of a distribution must be included in the participant’s gross income in the year of conversion.

- Amounts converted are not generally subject to the 10% early withdrawal tax. However, a new five-year holding period applies for each Roth conversion for purposes of the 10% early withdrawal tax.

- Roth in-plan conversions cannot be recharacterized.

In addition, participants in an employer-sponsored plan will want to consider these other key distinguishing factors in their individual situations (see also Figure 1 on pages 4–6):

- **Protection from creditors**: Under the rules of ERISA (Employee Retirement Income Security Act of 1974), employer-sponsored retirement plans may offer federal creditor protection (in situations such as bankruptcy or a civil lawsuit). Although IRAs enjoy similar federal bankruptcy protection, IRA assets may not be protected in the case of nonbankruptcy claims (for which state laws determine the level of creditor protection). For many investors, creditor protection is considered the most attractive benefit of an in-plan conversion versus a rollover to a Roth IRA.

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² Note that beneficiaries must take RMDs.
• **Investment options:** Although plan participants are limited to the investment options in their specific plan, they may have access to certain investments, or share classes, that might not be available otherwise. On the other hand, conversion to a Roth IRA provides the most flexibility in investment selection.

• **Lifetime RMDs:** Retirement plans are subject to RMDs when the participant turns 70½ or retires (whichever comes later). Roth IRAs are not subject to RMDs during the investor’s lifetime, so these assets may remain sheltered until death (but beneficiaries are subject to RMDs). Although participants can avoid RMDs from Roth assets by rolling them over to a Roth IRA before age 70½, they may then have to wait five years to take tax-free withdrawals from the earnings.

• **Recharacterization:** Plan assets that are converted to a Roth IRA can later be recharacterized—have the rollover treated as a traditional IRA rollover—as long as the recharacterization is completed by the applicable deadline (generally October 15 of the year following the year of conversion). As mentioned earlier, in-plan conversions cannot be recharacterized.

• **Loans:** Loans from the Roth conversion source may be available within a retirement plan, depending on the plan’s rules. On the other hand, loans are not available from Roth IRAs.

**Reference**

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**Figure 1. Converting to a Roth: Comparing an in-plan conversion with a Roth IRA conversion**

<table>
<thead>
<tr>
<th>In-plan Roth conversion</th>
<th>Plan to Roth IRA conversion</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Applicable law</strong></td>
<td>Small Business Jobs Act of 2010 (SBJA); modified by American Taxpayer Relief Act (ATRA), signed into law on January 2, 2013.</td>
</tr>
<tr>
<td><strong>Effective date</strong></td>
<td>September 27, 2010, and January 2, 2013, as modified by ATRA (applicable to conversions after December 31, 2012). In-plan Roth conversion is an optional provision that plan sponsors may decide to add. Only plans that permit ongoing Roth contributions may allow for in-plan Roth conversions; to offer such conversions, plans must be amended.</td>
</tr>
<tr>
<td><strong>Year of taxation</strong></td>
<td>Investors must pay taxes on any pre-tax amounts converted to a Roth. The taxable portion of the distribution must be included in gross income in the year of conversion.</td>
</tr>
</tbody>
</table>
| **Tax implications of converting** | - The variety and complexity of individual circumstances suggest that investors should consult a tax advisor before deciding whether to convert to a Roth.  
  - Investors must consider potential state/local tax implications, as well as quarterly estimated taxes, before converting. |
| **Early withdrawal tax** | Converted amounts withdrawn within five years after conversion are subject to a 10% early withdrawal tax for investors under age 59½. A new five-year holding period will apply for each Roth conversion for purposes of this 10% tax, regardless of whether an investor has previously made Roth contributions. |
In-plan Roth conversion

<table>
<thead>
<tr>
<th>Qualified withdrawal from a Roth</th>
<th>Plan to Roth IRA conversion</th>
</tr>
</thead>
<tbody>
<tr>
<td>A withdrawal is generally qualified (that is, tax-free) if the Roth source has been established for at least five years and:</td>
<td></td>
</tr>
<tr>
<td>• the participant is at least 59½ at the time of the withdrawal, or</td>
<td></td>
</tr>
<tr>
<td>• the withdrawal is due to the participant’s death or disability.</td>
<td></td>
</tr>
</tbody>
</table>

Recharacterization:

| In-plan Roth conversions cannot be recharacterized. |
| An investor who converts plan assets to a Roth IRA can later recharacterize the conversion and have it treated as a rollover to a traditional IRA, if it is recharacterized by the applicable deadline (generally October 15 of the year following the year of conversion). |

Assets available for conversion

| Under SBJA, to be eligible to convert traditional qualified plan money (pre-tax or after-tax) to Roth within the plan, a participant must otherwise have access to that money. Generally, this means the participant must either be eligible for an in-service withdrawal or have a distributable event under the plan’s rules. |
| Only amounts eligible for withdrawal may be converted to a Roth IRA. The provisions of ATRA do not change this. |

Effective January 1, 2013, plans may allow participants to elect to transfer any vested amount, distributable or otherwise, to a designated Roth account maintained under the plan for the participant’s benefit.

Conversion of after-tax amounts

| In general, a participant who converts after-tax plan assets to a Roth would owe taxes on the portion of the conversion that represents earnings on those after-tax assets. |
| Roth IRAs are not subject to RMD rules during the investor’s lifetime. Roth IRA assets can continue to grow tax-free until the investor’s death; however, the investor’s beneficiaries are then subject to RMDs. |

RMDs

| Roth plan accounts are subject to RMDs. In general, these rules require that when the participant turns 70½ or retires (whichever comes later), he or she must withdraw minimum amounts from the Roth plan each year. Although participants can avoid RMDs from Roth plans by rolling the assets to a Roth IRA before age 70½, they may then have to wait five years to take tax-free withdrawals from their Roth IRA earnings. |
| }
## Basis recovery rules for amounts distributed from Roth accounts

- “Nonqualified” distributions from a designated Roth account in an employer-sponsored plan must be made on a pro rata basis. Therefore, a nonqualified distribution would include an earnings portion, which would be taxable.

## First-time homebuyer expenses

- First-time homebuyer expenses do not count as a qualified distribution from a Roth in an employer-sponsored plan.

## Loans

- Money converted to a Roth within a retirement plan may be available for loans. Plan rules apply.

## Personal factors that investors should consider in deciding between an in-plan conversion and a direct rollover

### In-plan Roth conversion
- Inability to recharacterize conversion.
- Investment options and related investment expenses applicable if the money remains in the plan.
- Fees.
- Tax considerations.
- Control/flexibility.
- Consolidation.
- Lifetime RMD rules apply.
- Possibly stronger protection from creditors.

### Plan to Roth IRA conversion
- Ability to recharacterize conversion.
- Investment options and related investment expenses if the money is transferred to a Roth IRA.
- Fees.
- Tax considerations.
- Control/flexibility.
- Consolidation.
- Exclusion from lifetime RMD rules.
- More favorable basis recovery rules.

## Notes

This chart is provided for informational purposes only and should not be considered tax advice. Individual circumstances will vary, and account owners are encouraged to consult an experienced tax advisor before proceeding with any withdrawal or Roth conversion strategy. This chart may not cover all issues that an account owner should consider when deciding whether to complete a Roth conversion as well as whether the conversion should be made within a defined contribution plan or to a Roth IRA.