Submitted Electronically

March 11, 2013

Mr. George H. Bostick
Benefits Tax Counsel, Office of Tax Policy
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Re: **Request for Guidance on In-Plan Roth Conversions of Non-Distributable Amounts**

Dear Mr. Bostick:

The SPARK Institute appreciates this opportunity to provide input to the U.S. Department of the Treasury (the "Treasury") regarding the new Internal Revenue Code (the "Code") provision that permits certain in-plan Roth conversions of non-distributable amounts.[1] Our member companies include nearly all of the largest retirement plan record keepers.[2] They are the companies that plan sponsors and administrators turn to and rely on for help in understanding, implementing and operating plan features like in-plan Roth conversions.

The following is a summary of the issues and concerns we have regarding plan administration and record keeping for in-plan Roth conversions. This letter includes specific requests and recommendations with respect to certain issues where the Treasury's position is critical to record keepers' ability to support and provide the services that plan sponsors need to be able to offer conversions of non-distributable amounts. Certain other issues are identified in this letter without a specific recommendation because our

---

[1] American Taxpayer Relief Act of 2012 § 902, adding Code § 402A(c)(4)(E) (Pub. L. No. 112-240), effective January 1, 2013 ("ATRA").

[2] The SPARK Institute represents the interests of a broad-based cross section of retirement plan service providers and investment managers, including banks, mutual fund companies, insurance companies, third party administrators, trade clearing firms and benefits consultants. Collectively, our members serve approximately 70 million participants in 401(k) and other defined contribution plans.

members believe guidance is required, but they are generally impartial about the position taken by the Treasury.

I. Taxation and Reporting

A. Five-year recapture rule – What party is responsible for tracking any amount subject to recapture tax that could result from the distribution of converted amounts during the five-year recapture period?

Code Section 402A(c)(4)(D) states that Code Section 408A(d)(3)(F) applies to in-plan Roth conversions. Section 408A(d)(3)(F) provides for the "recapture" of early distribution penalties for distribution of amounts previously converted to a Roth Individual Retirement Account ("IRA") from a non-Roth account during a five-year wait period.

Q&A-12 in Internal Revenue Service ("IRS") Notice 2010-84[3] states the "5-year recapture rule in this Q&A-12 does not apply to a distribution that is rolled over to another designated Roth account of the participant or to a Roth IRA owned by the participant; however the rule does apply to subsequent distributions made from such other designated Roth account or Roth IRA within the 5-taxable-year period."

Additionally, the current instructions for Form 1099-R indicate that for distributions from in-plan Roth rollovers, the amount of the distribution subject to the recapture penalty under Code Section 72(t) should be detailed in box 10. The instructions further state that no amount should be detailed in box 10 if an exception applies that would prevent application of the penalty. Presumably, a rollover to another designated Roth account of the participant or to a Roth IRA would not be subject to a penalty, and as a result of being subject to an exception, no information would be reported. However, if an individual, after having converted to a Roth account, takes a distribution of the converted amounts from the Roth account during the 5-year recapture period, the recapture penalty would apply and certain reporting to the IRS would be required. Presumably, the only party that would be able to provide reporting in such circumstances would be the taxpayer.

The expansion of the permissibility of in-plan Roth conversions to include non-distributable amounts significantly increases the possibility that in-plan conversions will occur. Although all designated Roth amounts are subject to a five-taxable-year tracking rule for purposes of determining the qualification of distributions from the designated Roth account, the separate tracking associated with the five-year recapture rule introduces a significant layer of complexity. The number of conversions that any participant can initiate is potentially limitless

[3] IRS Notice 2010-84 was published prior to Code Section 402A(c)(4)(E) and did not contemplate in-plan Roth conversions of non-distributable amounts. It is considered herein in order to identify issues where guidance from the Treasury is needed.

(e.g., every year, every month or even every payroll). This creates the possibility of having to track and age, by tax year, each conversion that a participant initiates. Subsequent distributions from the converted account would need to apply FIFO rules, debiting amounts first from one year and then the next, and tracking the remainder. As each year passes, and a new batch of in-plan Roth conversions reaches the five-year mark, the original amounts of the in-plan conversions would need to be re-characterized and used to augment the value of the pool of converted amounts that are no longer subject to recapture.

We are very concerned about the administrative and record keeping complexities and burdens associated with tracking and managing the tax reporting aspects for these conversions. Plan sponsors will not be able to administer these complex requirements without the help and services of sophisticated record keepers. However, record keeping systems are not currently programmed to track multiple five-year periods for multiple and serial in-plan conversions on non-distributable amounts. The required changes and ongoing support will be extremely complex because of the data that must be tracked for each in-plan conversion, the subsequent calculations using that data, and the modification of the data fields to reflect distributions and the passage of time.

The costs associated with making these changes will likely be substantial and time consuming. Record keepers may not be willing to make the required changes before they know that plan sponsors will actually want and offer this feature.[4] Without sufficient demand and volume, it is unlikely that record keepers will be willing to spend significant resources to modify their systems to enable them to track the conversion amounts correctly and cost effectively.

Therefore, it is important to receive the guidance requested herein from the Treasury about what party will be responsible for these matters. Depending on the outcome of this question, record keepers may also have to limit the extent to which they will support plans that allow participants to initiate multiple and serial conversions. In the face of uncertainty about utilization, some may decide not to support this feature at all, if doing so requires costly system changes. Consequently, plan sponsors may not be able to offer this feature or may have to limit participants' ability to initiate multiple and serial conversions.

Recommendations: The tracking of any recapture tax associated with the distribution of converted amounts during the five-year recapture period should not be the responsibility of the plan sponsor, plan administrator, the plan or the payor

[4] Certain media reports published immediately after the passage of ATRA and surveys fielded during that same time frame suggested that plan sponsors may have been interested in adding this new feature to their plans. However, based on the collective information provided to The SPARK Institute by our member companies, it appears that as service providers and practitioners have studied the applicable provisions, learned of their complexities and uncertainties, and educated the plan community about such matters, interest in adding the feature has significantly diminished and stalled pending guidance from the Treasury.

for the plan. Instead it should be the individual's responsibility, as a taxpayer, as is the rule for Roth IRA conversions (and would be the rule for any amounts rolled from a qualified plan into a Roth IRA and then subsequently distributed before five tax years have elapsed). Each individual taxpayer should be responsible for tracking the converted amounts, and reporting and paying the penalty on any amounts distributed during the recapture period. This approach will increase the likelihood that plan sponsors will be able to offer this feature with the assistance of record keepers that are willing and able to support them on a cost-effective basis.

B. <u>Tax withholding - Does the plan administrator or payor for the plan have any federal income tax withholding obligations with respect to in-plan Roth conversions</u>?

IRS Notice 2010-84, Q&A-8, states in part that: "20% mandatory withholding under section 3405(c) does not apply to an in-plan Roth direct rollover. However, a participant electing an in-plan Roth rollover may have to increase his or her withholding or make estimated tax payments to avoid an underpayment penalty. See Publication 505, Tax Withholding and Estimated Tax."

An in-plan Roth conversion of non-distributable amounts would not qualify as an eligible rollover distribution because the amount in question is by its nature not distributable from the plan in any event. Clearly such amounts would not be subject to any mandatory withholding obligation. Additionally, it does not seem consistent with the non-distributable nature of such amounts to require plan administrators or payors to respond to any participant or beneficiary request for withholding from his or her account on a voluntary basis.

In connection with the rollover from a qualified plan to a Roth IRA, Internal Revenue Bulletin 2008-12, Q&A-6, states in part that "a distributee and a plan administrator or payor are permitted to enter into a voluntary withholding agreement with respect to an eligible rollover distribution that is directly rolled over from an eligible retirement plan to a Roth IRA. See section 3402(p) and the regulations thereunder for rules relating to voluntary withholding". Even this quoted language does not appear to require a plan administrator or payor to enter into such agreements in connection with the rollover of an eligible rollover distribution to a Roth IRA. In any event, however, the language quoted above from IRS Notice 2010-84 is different - it implies that any income tax withholding would be processed outside the plan.

Notwithstanding, if the Treasury contemplates a contrary conclusion, it would be extremely important to provide additional guidance for plan administrators and payors. Withholding income taxes from an amount not distributable under the plan would raise a number of questions not addressed by the statutory language or guidance issued to date. For example, guidance would be needed to decide how

to allocate the withdrawal among various account sources and any special requirements for the corresponding tax reporting.

C. Characterization of in-plan Roth conversions

1. Is an in-plan Roth conversion technically considered a distribution for purposes of applying special tax treatment to any remaining unconverted stock in the plan (i.e., net unrealized appreciation ("NUA") treatment)?

   Code Section 402A(c)(4) refers to these in-plan Roth conversions as distributions. However, Q&A-3 in IRS Notice 2010-84 states that an in-plan Roth direct rollover is not treated as a distribution for several purposes. This creates uncertainty with respect to the rules governing unrealized stock appreciation, and more generally, whether in-plan conversions of non-distributable amounts should be treated as distributions for only some purposes of the plan pursuant to the principles set forth in IRS Notice 2010-84.

   Q&A-7 of IRS Notice 2010-84 states that the taxable amount of an in-plan Roth rollover is equal to the fair market value of the distribution reduced by any basis the participant has in the distribution. Q&A-7 further states that if the distribution includes employer securities attributable to employee contributions, the fair market value includes any NUA within the meaning of Code Section 402(e)(4). This would seem to indicate that if amounts invested in employer securities are converted, the cost basis of the converted shares is reset to the fair market value at the time of the conversion. This would also seem to indicate that the in-plan Roth conversion is being treated as a distribution other than a total distribution, followed by a rollover.

   Clarification is requested to confirm that the conversion of any amount would not preclude any future NUA treatment based on the lump sum distribution requirement related to employer securities attributable to employer contributions. Q&A-3 of Notice 2010-84 indicates that "[b]ecause an in-plan Roth conversion merely changes the account in a plan under which an amount is held and the tax character of the amount," an in-plan Roth conversion is not treated as a distribution for all purposes. Since an in-plan Roth conversion does not result in a true distribution from the plan, the ability to use the NUA rules for a later in-kind distribution of unconverted employer securities is appropriate. If a partial conversion of employer securities results in loss of NUA treatment for the remaining shares, then plan sponsors will be forced to exclude employer securities from in-plan Roth conversions. The NUA rules are complex and forcing participants to choose between in-plan Roth conversion or NUA treatment would require sophisticated financial and tax advice, which could have a negative impact on choosing an in-plan Roth conversion option.

2. For purposes of the top heavy rules under Code Section 416, please confirm that conversion of a distributable amount will be treated as a related rollover and conversion of a non-distributable amount will be included in the determination of a plan's top-heavy status as if the conversion had not occurred.

D. Impact of compliance testing failures - What is the impact of failed ADP/ACP tests, or excess deferrals?

For example, assume a participant defers $10,000 pre-tax during the 2013 plan year, and does an in-plan conversion of the full amount prior to year-end ($10,500, including earnings). Subsequently, the plan fails the ADP Test, and that individual has excess contributions of $2,000 that need to be corrected ($2,100, including earnings).

How should a plan sponsor handle this situation and what are the tax consequences? We believe the best approach for handling the distribution of the $2,100 excess in 2014 is to report the in-plan Roth conversion and subsequent corrective distribution from the Roth account as two distinct transactions, as follows:

(1) a 2013 Form 1099-R reporting a taxable in-plan conversion of $10,500, and
(2) a 2014 Form 1099-R reporting a $2,100 corrective distribution of non-taxable Roth basis, plus a taxable pro-rata earnings piece related to the non-qualified Roth distribution actually paid out of the plan.

Our reasoning for this reporting approach is that in most instances neither the plan sponsor nor the record keeper will know prior to January 31st of the year following the testing year in which the failure occurred that corrective distributions will be necessary. In reality, most service providers will not have completed the compliance testing before the deadline for 1099-R reporting. An approach that necessitates issuing a corrected 1099-R will be extremely confusing and disruptive for participants. We believe that separating the reporting according to our recommendation would be the least disruptive and more understandable for participants.

We request similar guidance with respect to the following situation. Assume a participant makes after-tax contributions to a plan during the 2013 plan year, and converts all of those amounts to a Roth rollover source through an in-plan conversion. Subsequently it is determined that refunds are due as a result of a failed ACP test. How should a plan sponsor handle this situation and what are the tax consequences? Can the corrective distribution be paid from the Roth rollover source?

II. Matters Concerning Plan Design, Flexibility and Restrictions

Based upon the collective experiences of our member companies, The SPARK Institute believes that plan sponsors will request various designs and alternatives in how they may offer the new in-plan Roth conversion feature for amounts that are not otherwise distributable. Such designs and alternatives could arise from or be dictated by certain other plan complexities or limitations, by record keeping system requirements or limitations, or for various other reasons. We request that the Treasury permit flexibility in regards to plan design issues and provide guidance regarding possible limitations on the following plan design features and alternatives.

Please note that for purposes of these matters and questions we are assuming that any such converted amounts remain subject to any distribution restrictions (and other plan restrictions, if applicable) that were applicable prior to the in-plan Roth conversion. We make this assumption in light of the fact that the recent legislative changes included no waiver of such distribution restrictions. This is a fundamental assumption which gives rise to complexities not present with respect to conversions of distributable amounts (not the least of which, as noted above, is maintaining one or more separate accounts in order to preserve applicable restrictions or other characteristics), and thus raises additional design questions. However, if this fundamental assumption is incorrect – i.e., if a conversion could cause a converted amount to become free of applicable Code withdrawal restrictions – immediate clarification would certainly be critical.

A. Conversion logistics - We are not aware of any mechanical requirements that an in-plan conversion, whether of distributable or non-distributable amounts, results in the actual surrender or sale, and subsequent repurchase, of underlying plan investments, so long as the record keeping system maintains the necessary corresponding records and generates the corresponding tax reporting. Nor are we aware of any prohibitions against such mechanical steps in order to facilitate appropriate record keeping processes or in order to reset cost basis, where appropriate, for shares of stock affected by the Roth conversion, provided (with respect to non-distributable amounts) that no actual distribution from the plan actually occurs. We request confirmation that such mechanics are neither required nor prohibited.

B. Frequency limitations - As with the prior in-plan conversion rules, we are not aware of any frequency limitations (or restrictions on frequency limitations) upon these in-plan conversions in the recent legislation or in the related Code provisions. We request confirmation of this conclusion, or alternatively, clarification as to any types of guidance with respect to conversion frequency that the Treasury may be contemplating. As for plan-imposed frequency limitations, we believe some plan sponsors will want to impose limited restrictions provided that such restrictions are not inconsistent with applicable nondiscrimination requirements. For example, a plan might require participants seeking to convert contributions to Roth amounts to do so periodically with a separate request, and

not permit them to be converted automatically on a serial basis each time contributions are deposited into the plan account.

C. Type/source limitations - A plan sponsor may want to restrict in-plan Roth conversions of non-distributable amounts to one or more contribution sources or other plan subaccounts. For example, a plan with up to eight separate subaccounts for a participant (which could arise from a mix of multiple contribution sources and various legacy plan accounts) may not wish to potentially double that to sixteen subaccounts for a participant, and may thus elect to restrict conversions to a subset of those eight subaccounts. As another example, while the legislation does not appear to restrict such conversions to vested amounts, a plan sponsor might want to exclude a contribution source with a vesting schedule from eligibility for in-plan Roth conversions, or at a minimum exclude non-vested amounts in such a contribution source from those conversions. Such a restriction would help prevent a participant from paying taxes upon conversion with respect to amounts that are subject to forfeiture. We request confirmation that such limitations or restrictions are permissible.

D. Participant contribution source elections - It is conceivable that, in the event a plan permits in-plan Roth conversions of non-distributable amounts from more than one contribution source, some plans will permit participants to choose which contribution source(s) to use, while other plans may either require, or establish as a default (absent participant election) that a requested conversion would occur pro-rata across all available contribution sources. We are not aware of any restrictions in the legislation as to either of these options. We request either confirmation of this conclusion or clarification as to any potential restrictions.

E. Rollover limitations - Must a plan that allows in-plan Roth conversions also permit rollover contributions of designated Roth assets from other qualified plans? Plans are required to permit contributions to a designated Roth account before allowing Roth conversions. Code Section 402A(c)(4)(B) refers to an amount converted as a "qualified rollover contribution." It is not clear whether permitting such "rollover contributions" would obligate the plan sponsor to also permit rollovers of designated Roth contributions from other qualified plans. A plan sponsor may want to permit in-plan Roth conversions, of either distributable or non-distributable amounts, but still not accept incoming Roth rollovers. Also, the plan may elect to limit the in-plan conversion right to those participants otherwise eligible for a rollover from outside of the plan. Neither the prior nor the most recent legislation appear to restrict such bifurcation. We request either confirmation of this conclusion or clarification as to any such restrictions.

III. Plan Amendments

A. Will a remedial amendment period be provided for amending plans to add the in-plan Roth conversion feature for non-distributable amounts? If so, how long will it be?

Generally, discretionary plan amendments must be adopted by the last day of the plan year in which they take effect. However, the amendment deadline is frequently amended by the Treasury in order to prevent substantial hardship to a plan sponsor, promote the best interests of the plan's participants and advance the government policy and interests under Code Section 401(b) and Treasury Regulation Section 1.401(b)-1(f).

Prior to implementing in-plan Roth conversion features for non-distributable amounts, Treasury guidance is needed, which must then be analyzed by plan sponsors, their counsel and service providers. It may not be possible or practical for plan sponsors to decide to add the new conversion features until very late in 2013.

Recommendations: The SPARK Institute recommends a remedial amendment period ending on the last day of the 2014 plan year for an amendment adding this feature in the 2013 plan year. This will allow plan sponsors adequate time to consider this feature and increase the possibility that participants will have the feature available in 2013.

B. May an in-plan Roth conversion feature be added mid-year to a 401(k) plan that is intended to satisfy the safe harbors under Code Section 401(k)(12) or (13)?

If the answer to this question is yes, are there any special requirements with respect to the timing for the adoption of such an amendment for a safe harbor 401(k) plan?

C. Is the Treasury planning to develop and provide a model amendment?

IV. Participant Tax Effect Notice

How should the tax effects, and other rights and obligations, of an in-plan Roth conversion of non-distributable amounts be communicated to participants?

An in-plan Roth conversion of non-distributable amounts will accelerate the taxation of plan contributions and earnings not contemplated under the existing participant notice guidelines. Explaining the effect of and rules related to, non-distributable and distributable in-plan Roth conversions will be extremely cumbersome and complex. In particular, for participants who are eligible to convert both non-distributable and distributable account balances, explaining the differences in the treatment of these conversions in language understandable to the participants will be challenging. Including a complex and lengthy explanation about these matters, that is likely to be

of interest to a limited number of participants does not seem to fit well with the existing purpose and language of the more general Section 402(f) Special Tax Notice.

Recommendations: Given the complexities of explaining in-plan Roth conversions, we request that the Treasury allow plan administrators broad flexibility on how and in what form to provide a description of the tax effect of in-plan conversions. This would include the discretion to include any required notices and explanations in the summary plan description, in transaction request forms and related paperwork, in the 402(f) Special Tax Notice, or in a separate disclosure that could be provided to participants upon request. We request that the Treasury develop and provide sample language describing non-distributable and distributable in-plan Roth conversions, the 10% early withdrawal excise tax recapture, conversion ordering rules, and basis and earnings allocations.

* * * * *

Thank you for considering our views and recommendations on these very important issues. Please do not hesitate to contact us at (704) 987-0533 if you have any questions about our request.

Respectfully,

Larry H. Goldbrum
General Counsel