



John Jeffrey, J.D.,
Corporate Counsel,
Alerus Financial

Roth conversions inside a 401(k) plan

The Small Business Jobs and Credit Act of 2010 was signed into law on September 27, 2010. Among its many provisions, the new law allows employers to include a Roth conversion feature within their 401(k) plans. In addition to making Roth 401(k) contributions, plan participants can now convert

certain pre-tax amounts to a Roth account without taking a distribution from the plan. Prior to the change in the law, plan participants could accomplish a Roth conversion by a direct rollover from a 401(k) to a Roth IRA. This new provision gives participants the convenience of making the Roth conversion in the plan without the need for a rollover.

what's a Roth 401(k)? The concept of a Roth 401(k) is best understood when compared to a traditional 401(k). The two arrangements have opposite treatment regarding the timing of income taxation. The traditional 401(k) is not taxed at the time that the employee makes the contribution. However, upon distribution, the contribution plus earnings is taxable. In contrast, the Roth 401(k) contribution is taxed in the year it is made. Then if the employee meets certain distribution criteria (e.g. holds the account for at least 5 years and is age 59½), the original contribution plus earnings is all tax free.

what's a Roth conversion? A Roth conversion occurs when a plan participant elects to transfer some or all of a pre-tax account into a Roth account. The conversion results in immediate taxation on the converted amount. However, the converted amount and all earnings are then treated just as a Roth 401(k) at the time of distribution.

plan considerations. Before including a Roth conversion feature within a plan, an employer should consider the following:

- **A Roth conversion only applies to the portion of the account that can be distributed.** Merely having a Roth conversion feature does not allow the plan participant to convert the entire pre-tax account to a Roth. In order to convert, the pre-tax amounts must be eligible for distribution.

example: John is employed by XYZ Corp. and is age 50. His retirement account consists of \$150,000 in pre-tax contributions. He has \$50,000 of traditional 401(k) deferrals and \$100,000 which he rolled from a previous employer. The XYZ Corp. plan permits employees to withdraw rollovers at any time and 401(k) deferrals at age 59½. It has a Roth conversion feature. John may convert his \$100,000 rollover account into a Roth account within the plan. However, he is age 50 and cannot take a distribution of his 401(k) deferrals while employed. Since the 401(k) amount of \$50,000 is not distributable, he may not convert that portion of his account into a Roth.

- **A participant can still accomplish a Roth conversion even without this provision.** Whether or not a plan offers a Roth conversion feature, a plan participant may make a direct rollover of distributable amounts to a Roth IRA. However, the new law permits the employee to make the conversion without leaving the plan. The advantage of converting within the plan is twofold. First, the participant does not have to sell the mutual fund investment in the 401(k) and then reinvest in the Roth IRA. The conversion from pre-tax to a Roth account is merely an accounting entry within the plan. It does not require the sale and eventual repurchase of mutual fund shares. Thus, the participant avoids potential transaction costs and trading risk in a volatile mutual fund market. Second, the participant can continue to use the same diversification strategy he or she previously used. There is no need to monitor

separate 401(k) and IRA accounts. The investments are not affected by the decision to convert from pre-tax to a Roth account.

Assume the same facts as above, except that John's plan does not offer a Roth conversion feature. John can request a direct rollover distribution of his \$100,000 to a Roth IRA. This transaction has the same tax consequences as if he had made the conversion to a Roth within his employer's retirement plan. However, he must liquidate his investment within the plan and then repurchase \$100,000 of mutual fund shares within his Roth IRA. If the mutual funds have sales charges, he incurs transaction fees. In addition, he now has two accounts to monitor when determining his proper investment allocation.

- **The Roth conversion is taxable.** Even though the conversion occurs entirely within the plan, it still triggers ordinary income. The conversion is not subject to the 10% excise tax for early withdrawal. However, it is ordinary income. The plan participant will receive a Form 1099 for any pre-tax amount converted to a Roth account and must recognize the conversion amount as income in the year of the transaction.

Continuing the above example: although John avoids the 10% excise tax on the conversion, he still must recognize \$100,000 of taxable income in the year of conversion.

- **Roth conversions in 2010 may be taxed in 2011 and 2012.** Generally, a Roth conversion triggers ordinary income in the year that it occurs, but the new law has an exception which applies only for conversions that occur in 2010. The taxpayer may choose to recognize the 2010 conversion as income in 2010. In the alternative, the taxpayer may recognize one half of the converted amount in 2011 and the balance in 2012.

Continuing the above example: If John made the conversion in 2010, he could choose to recognize the entire \$100,000 as additional income in 2010. In the alternative, he could elect to recognize \$50,000 of income in 2011 and \$50,000 in 2012.

- **The plan must be amended.** If the employer decides to offer the Roth conversion feature, its

plan must be amended and participants must receive a Summary of Material Modifications explaining the change.

- **The plan must offer a Roth 401(k).** In order to offer the Roth conversion feature, the plan must also permit employees to make ongoing Roth 401(k) contributions from their pay.

general considerations when converting. A taxpayer should consider the following when deciding whether to convert to a Roth account:

- Roth conversions primarily benefit high income, high net worth participants. The best candidate for a Roth conversion is someone who is currently in a top income tax bracket and anticipates higher income tax brackets at the time of retirement.

For example, Tom earns \$400,000 annually. He anticipates that even in retirement his income will remain at that level or higher. He is concerned that income tax rates on wealthy individuals will increase in future years. He has \$500,000 in his 401(k) account eligible for a Roth conversion. He converts the amount now and pays the income tax using today's rates rather than delaying payment to a future date with potentially higher income tax rates.

- **Congress can change the tax code.** A Roth conversion is made with the expectation that the tax code will provide preferential treatment to Roth distributions at the time of retirement. However, there is never a guarantee when it comes to tax policy. Congress has the ability to change the law. For example, Congress could create a means test similar to the current law that makes social security payments taxable if a combination of gross income and social security exceed a threshold amount.
- **Investments may not appreciate.** A Roth conversion is expected to grow in value, so that the participant can withdraw both the converted amount and any appreciation tax free. However, this tax strategy may backfire if the investment loses value. In that scenario, the participant will have paid income tax on the entire converted amount, but the actual amount available for distribution will be less. The participant paid income tax on amounts that he or she will never receive.

conclusion. A Roth conversion feature provides potential tax advantages, but the benefits tend to be most useful for high income participants. Including the conversion feature within the plan gives these individuals the convenience of converting to a Roth account without having to do a rollover. They can maintain a single account, retain their current diversification strategy and avoid transaction costs incurred when selling and then reinvesting in a volatile market.

Like all new plan provisions, employers should consider a Roth conversion feature in light of participants' needs. Alerus would welcome the opportunity to discuss these and other issues which may affect plan participants. Feel free to give us a call.

fall 2010

investment update



Sunil Swami,
President and
Chief Investment Officer,
Alerus Investment Advisors

stocks: stocks rebound as double-dip worries fade

Economic data surprised investors on the upside in September causing the stock market to post sharp gains for the month and for the third quarter. The Dow Jones Industrial Average rose 10.4% in the third quarter and is now up 3.5% for the year. The broad Standard and Poor's 500-stock index was up even more—10.7%.

Stocks were also supported by comments from the Federal Reserve to inject money into the financial markets through purchases of U.S. Treasuries. With unemployment stuck at 9.6% and inflation below its targets, the Fed was compelled to act in support of the economy.

There were no major themes in the stock market except for the financial sector, which lagged behind other sectors. New regulations, consumer de-leveraging, and investor fears about a possible double-dip in the housing market hurt financial stocks. Industrial and material stocks with exposure to strong growth in emerging markets lead the way. Caterpillar gained 31%

in the third quarter and DuPont was up 29%. Bank of America, the nation's largest bank, declined almost 9%. Lead by faster growth in emerging markets, international stocks did better than U.S. stocks. The Dow Jones World Index (excluding U.S.) rose 15.9% in the third quarter. Sri Lanka was up 60% and Indonesia and Thailand were both up more than 20%. Strong national balance sheets and better growth than developed markets have caused stocks in these countries to trade at a premium. With bank stress tests behind them, Europe recovered and was up 6.2% for the quarter. Norway and Finland, both up over 14%, were the best performers.

bonds: liquidity and quantitative easing fuels rally

During the third quarter, investors placed almost \$88 billion into bond funds while pulling \$43 billion from stock funds. As the economy slowed and unemployment continued to stay high at 9.6%, the Federal Reserve announced it would reinvest interest earned on bonds to purchase additional Treasuries. This liquidity and the Fed's promise to keep interest rates low for an extended period continued to support the bond market. For the third quarter, Treasuries returned 2.7%, investment grade bonds 4.9%, and high-yield corporate bonds 6.5%.

With unemployment high, capacity utilization low, and deflationary pressures expected to continue, we anticipate the Federal Reserve to maintain the Fed Funds rate near

zero for some time. In this environment, fixed income should continue to offer returns superior to cash.

commodities: severe weather and printing money offer tailwind

Severe drought followed by a ban on wheat exports by the Russian government caused wheat prices to explode—up by 45% in the third quarter. The wheat price spike helped other agricultural commodity prices—corn was up 39.9% and soybeans up 16.7%. The Dow Jones-UBS Commodity Index rose 11.6% for the quarter. Dry weather in Brazil and floods in Pakistan drove prices higher for sugar and cotton. Growing demand for commodities in emerging markets, particularly China, supported industrial metal prices with copper, lead, and nickel all up 18% to 40% for the quarter.

As economic growth slowed significantly in the U.S. in the second quarter, the Federal Reserve made it clear it would engage in quantitative easing to support the economy. Investors, fearing that this would devalue paper currency, poured money into precious metals such as gold and silver. Gold prices exceeded \$1,300 per troy ounce and silver rose almost 17% during the quarter.

outlook: the hangover is upon us

Over the past twenty years U.S. consumers assumed too much debt to buy too many homes, cars, and other big-ticket items they could not afford. In 2008 the bubble burst and we faced the abyss. Governments around the world stepped in with bank bailouts and fiscal spending programs. These actions helped stabilize the global economy. Credit markets began functioning again and stocks rebounded. Now, however, with fiscal stimulus fading, the economy will depend on consumer demand once again. However, consumers are reducing

debt, increasing savings, and not spending. Over 20% of home mortgages are underwater and banks are hoarding capital rather than lending. Thus demand for credit and credit creation are sub-par, resulting in a sub-par recovery that cannot create sufficient jobs to bring the unemployment rate down. We are stuck in a negative feedback loop—or an economic hangover. It might take us a few years to get out of this mess.

Under these conditions inflation should remain low and might even decline. The Federal Reserve expects to maintain near zero interest rates for an extended period. Fixed income assets should continue to offer solid real rates of returns. With central banks around the world pumping money into the economy to support asset prices, we believe investors will increasingly shift to precious metals as an alternative currency. Gold and other precious metals have benefited and should continue to benefit from this trend.

Investors with longer time horizons, however, should consider risk assets that offer value. Housing prices are down 30-35% from their peak and interest rates are at historically low levels. We believe 2010 could prove to be a good time to buy a new home or trade up to a more expensive home. In many parts of the country, housing prices have stabilized and many homes are selling below their replacement costs. We also like large, high quality U.S. multinational companies with strong balance sheets, cash flows, and significant exposure to high growth emerging markets—companies such as IBM, McDonalds, Colgate, Abbott Laboratories, and United Technologies.

Sources: Wall Street Journal, Bank of America Merrill Lynch, Goldman Sachs

The opinions within this letter are intended for informational purposes only and subject to change without notice, and past performance is not indicative of future results. Alerus Investment Advisors Corporation, a registered investment advisory firm, is a subsidiary of Alerus Financial, N.A. Investment products: 1) are not FDIC insured; 2) are not deposits or obligations of a bank; and 3) involve investment risk, including possible loss of the principal amount invested.

The logo for Alerus Retirement Solutions features the word "Alerus" in a large, blue, serif font with a stylized blue swoosh underneath. Below "Alerus" are the words "RETIREMENT" in a smaller, blue, sans-serif font, and "Solutions" in a blue, serif font.

Alerus
RETIREMENT
Solutions