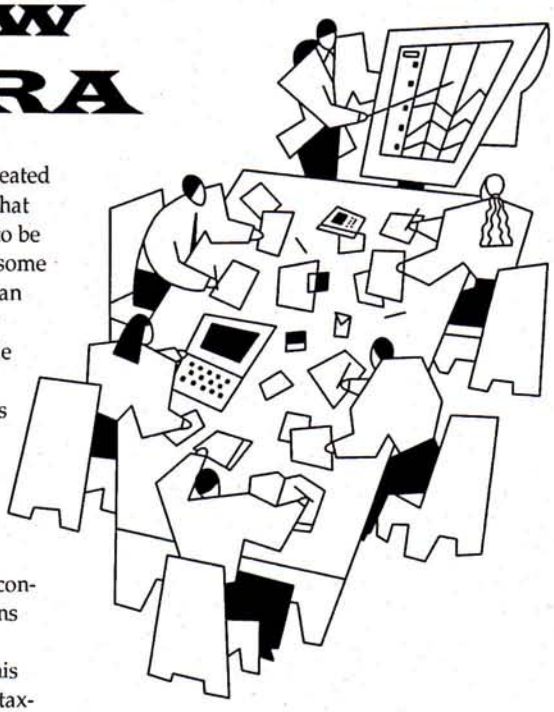
THE Pension Digest

Published Since 1984 Collin W. Fritz and Associates, Inc., *"The Pension Specialists"* August, 1997

The New Roth IRA



The Taxpayer Relief Act of 1997 has created a new type of IRA, called the Roth IRA, that many individuals will think is too good to be true. This IRA has been talked about for some time. In the past it was called the American Dream IRA and the IRA Plus. It is finally reality under the name "Roth IRA." While the short-term benefits of this new IRA may not be as great as the regular IRA, its long-term benefits cannot be matched. The Roth IRA is funded with after-tax contributions. This means that accountholders will not receive any tax deduction for contributions they make to this account. The most important tax benefit connected to the Roth IRA is that distributions will not be taxed at all if the distribution requirements for this account are met. This means that all growth in the Roth IRA is tax-free, not just tax-deferred, as is the case with a regular IRA.

This article will examine some of the general rules that will govern the Roth IRA. It will cover contribution rules, distribution rules, rollover and transfer rules, and the treatment of excess contributions. Unfortunately, at the time of this writing the IRS has not yet determined a number of issues relating to the Roth IRA. These include plan document requirements and IRS reporting requirements. While we do not yet know what these will be, we will try and provide our "best guess" based on our experiences with IRAs and the IRS.

Prepare for a Very Busy 1998 IRA Season

ELIGIBILITY & CONTRIBUTION RULES

Eligibility Rules

The first issue to examine with the Roth IRA is who will be eligible to use this type of IRA account. While most individuals will be eligible to make contributions to this type of IRA, some will not.

1. Earned Income - As with a regular IRA account, the accountholder must have earned income in order to make a contribution to a Roth IRA. Earned income for the Roth IRA has the same definition as it does for a regular IRA account.

2. Income Limitation and Tax-Filing Status - As stated, the first eligibility requirement for a Roth IRA is that the accountholder have earned income. The second requirement is that the accountholder not have too much earned income. Individuals whose income levels exceed a certain point are not allowed to contribute to a Roth IRA. The income levels where the ability to contribute to a Roth IRA is phased out depends on the accountholder's tax-filing status.

Individuals whose income exceeds the following levels cannot make a Roth IRA contribution.

Single	**$110,000.00**
Married, Filing Joint Return	**$160,000.00**
Married, Filing Separate Return	**$ 0.00**

One interesting point to note is that married individuals who file separate tax returns are not eligible to make any contribution to a Roth IRA.

It is also important to note that similar to the IRA deductibility rules for a regular IRA, contributions to the Roth IRA are phased out over certain income ranges. This topic will be discussed later in this article.

3. Age Limit? - The regular IRA rules state that once an individual attains age 70 1/2, they are no longer eligible to make a regular IRA contribution. The Roth IRA does not have an age limit under its eligibility rules. This means that contributions can continue to be made to a Roth IRA even after the accountholder has attained age 70 1/2, as long as the accountholder has earned income. This rule opens up a whole new market for IRA deposits. Individuals who are over age 70 1/2 and continue to work, will not have to stop funding a Roth IRA as they do with a regular IRA.

4. Spousal Contribution Eligibility - The eligibility rules for spousal contributions to a Roth IRA are the same as for a regular IRA with the exception that Roth IRA contributions do not have to end at age 70 1/2.

Contribution Rules for the Roth IRA

The contribution rules for the Roth IRA are both similar to and coordinated with the contribution rules for regular IRA accounts. The rules relating to regular contribution amounts, spousal contributions, the tax impact of a contribution to the Roth IRA, and anticipated reporting requirements related to contributions and the fair market value of the Roth IRA are all discussed here. Contributions to the Roth IRA are made with after-tax dollars. The

Continued on page 2

*Published by Collin W. Fritz and Associates, Ltd.
Subscription Rate: $65 per year.*

Roth IRA—*Continued from page 1*

accountholder does not receive a tax deduction for contributions to the Roth IRA.

Contribution Amounts

Regular Contributions - The amount that can be contributed to a Roth IRA is generally the same as with a regular IRA. An individual can contribute the lesser of $2,000 or 100% of their earned income. The contribution amount to a Roth IRA may, however, have to be adjusted. An adjustment to the contribution amount to a Roth IRA needs to be made if any regular IRA contributions were made and if the individual's income exceeds a certain level. Both of these situations will be looked at here.

Regular and Roth IRA in the Same Year - The amount an individual is eligible to contribute to a Roth IRA must be reduced by the amount of any contributions made to a regular IRA for the same tax year.

While it is permissible to contribute to both a regular and a Roth IRA in the same year, the total contributions to both types of IRAs for one tax year may not exceed the $2,000 amount.

Example - Steve Crawford made a $500 contribution to a regular IRA on March 2, 1998, for the 1998 tax year. He would be permitted to contribute $1,500 to a Roth IRA for the 1998 tax year.

Adjustment for Income - If an individual's income exceeds a certain level, they will begin to lose the ability to contribute funds to a Roth IRA. At a certain point, they lose the ability to make any contribution to the Roth IRA. This was mentioned previously in this article when the eligibility rules for the Roth IRA were discussed.

The amount an individual can contribute to a Roth IRA depends on income and tax-filing status. Up to a certain level of income, an individual will be eligible to contribute up to $2,000 to the Roth IRA, assuming no regular IRA contributions were made. Individuals who exceed this income level will have their contribution amount phased out until income reaches a level where no Roth IRA contribution is permitted at all. These levels depend on the individual's tax-filing status and are produced below.

Tax Filing Status	Threshold Level	Phaseout Level
Single	$ 95,000	$110,000
Married Filing Joint Return	$150,000	$160,000
Married Filing Separate Return	$ -0-	$ -0-

What this table means is that a single individual who earns less than $95,000 can contribute the full $2,000 amount to the Roth IRA. The same is true for a married couple filing a joint return that earns less than $150,000. Married individuals who file separate tax returns may not contribute to a Roth IRA.

A single individual who earns more than $110,000 and a married couple that earns more than $160,000 may not make any contribution to a Roth IRA.

Those individuals who fall between the threshold and phaseout levels must use a special formula to determine how much they can contribute to the Roth IRA for a year. The formulas used for a single individual and a married couple filing a joint return are different. They are shown below along with examples of how they work.

<u>Single Taxpayer Formula</u>:
Adjusted Gross Income - $95,000/$15,000

<u>Married Filing Joint Return</u>:
Adjusted Gross Income - $150,000/$10,000

These formulas will provide a ratio that must be multiplied by the amount the individual would be eligible to contribute absent the income limitations or, in other words, $2,000 minus the amount of any regular IRA contributions. The result of this calculation is the amount that the contribution must be reduced by to determine what amount the person can contribute. Some examples are in order to demonstrate how these formulas will work.

Example 1 - Valerie Johnson has made no regular IRA contribution in 1998. She is a single taxpayer who earned $105,000 in 1998. She wishes to make a contribution to a Roth IRA. How much can she contribute?

The formula to calculate Valerie's Roth IRA contribution is shown here.

Step 1	$105,000 - $95,000 / $15,000
Step 2	$10,000 / $15,000 = .666666667
Step 3	$2,000 X .6666666667 = $1333.33
Step 4	$2,000 - $1,333.33 = $666.67

Valerie could contribute up to $666.67 to a Roth IRA for the 1998 tax year.

Example 2 - Harold and Thelma Hall earned $154,000 in 1998 and file a joint tax return. They each had income that exceeded $2,000 in the year. They wish to make contributions to Roth IRAs. How much can each contribute to a Roth IRA?

Step 1	$154,000 - $150,000 / $10,000
Step 2	$4,000 / $10,000 = .4
Step 3	$2,000 X .4 = $800
Step 4	$2,000 - $800 = $1200

This formula must be performed separately for each spouse but is based on their combined income. Harold and Thelma could each contribute up to $1,200 to a Roth IRA in 1998.

Spousal Contributions - The spousal contribution rules governing the total spousal contribution amount are basically the same as the regular IRA. The total contribution that a married couple may make to their Roth IRAs may not exceed $4,000 for the year. Neither one of their Roth IRAs can receive more than $2,000.

Limitations - Spousal contributions have the same limitations as were previously discussed with regular contributions. The spousal contribution amounts must be reduced by the amount of any regular IRA contributions and may be limited by income as was previously illustrated.

Contribution Deadline

The deadline for making Roth IRA contributions is the same as for regular IRAs. It is the due date for individual tax returns, normally April 15, not including any extensions.

Contribution Reporting

At the time of this writing, nothing is known relating to the reporting requirements for contributions to a Roth IRA. The IRS has not yet released any information on this topic.

We anticipate that the contribution and fair market value reporting requirements for the Roth IRA will be very similar to the regular IRA. The regular/spousal contribution amount for a tax year, any rollovers, and the fair market value of the account is the type of informational reporting we anticipate. We do not know if the IRS will attempt to incorporate this information onto the current Form 5498 or will devise a new type of Form 5498 just for the Roth IRA. The year-end fair market value statement requirement that applies to regular IRAs also appears to apply to the Roth IRA. It would not surprise us if the IRS were to add another checkbox to the current 5498 that would allow an institution to designate that particular 5498 as being for a Roth IRA. We are virtually certain that an institution will not be able to combine Roth IRA and regular IRA reporting on one 5498, even if the IRS does incorporate information for both onto the current 5498 report. As the tax rules for the two types of IRAs are so different, the IRS will need to be able to track contributions and the fair market value of the two types of IRAs separately. Watch future issues of this newsletter for updated information on the IRS reporting requirements.

DISTRIBUTION RULES FOR THE ROTH IRA

The primary benefit and the most attractive feature of the Roth IRA occurs at the time distributions are made from the account. If the distribution rules for the Roth IRA are com-

Continued on page 3

Roth IRA—*Continued from page 2*

plied with, there will be no income tax owed at the time of distribution. This means that all the earnings and growth experienced by the account is distributed tax-free. This section will explore the distribution requirements that must be complied with in order to receive the distribution free of taxes, what happens if the rules are not complied with, and look at the potential reporting requirements.

Qualified Distribution

A distribution from a Roth IRA will not be subject to income tax if it is a "qualified distribution." A "qualified distribution" is one that occurs after a specified period of time and for a specified reason.

Period of Time - In order to be a qualified distribution, the distribution from a Roth IRA must occur after the five-year period that begins with the first tax year for which the individual made a contribution to a Roth IRA. This means that if an individual makes a contribution to a Roth IRA for 1998, they will not be able to take a "qualified distribution" until 2003. Based on the way the new Code is written, it appears to us that the five-year period does not apply separately to each individual Roth IRA plan agreement and definitely not to each contribution separately. It seems to us that the five-year period begins with the first tax year that the individual makes a contribution to any Roth IRA.

There is also an unanswered question with the five-year period that needs to be addressed by the IRS. The new Code section seems to indicate that the five-year period begins with the year the individual or the individual's spouse makes a contribution to a Roth IRA. The confusing part is that the Code seems to indicate that the five-year period would begin for both spouses in the year one or the other makes a Roth IRA contribution. This indicates that if one spouse contributes to a Roth IRA in 1998, the other makes their first Roth IRA contribution in 2000, the first year that either one could take a qualified distribution would be in 2003. This does not make a lot of sense and we anticipate further clarification from the IRS.

Special Rules for Rollovers

The five-year rule is applied differently for any rollover contributions to a Roth IRA from a regular IRA. As will be seen later in this section, individuals who currently have a regular IRA will have the ability to roll these funds to a Roth IRA. If an individual does this, the five-year period for the rollover funds begins with the taxable year the rollover contribution was made. In other words, rollover contributions from regular IRAs must be tracked separately for distribution purposes. This may very well mean that it would be best to require that any rollovers from a regular IRA be made to a Roth IRA that is separate from a Roth IRA where normal contributions are being made. Keeping the rollover funds in a separate Roth IRA would make tracking for the five-year requirement much simpler than would be the case should the funds be mixed.

Reasons for Distributions - As already seen, the first requirement that must be met for a distribution to be a "qualified distribution" is that the five-year rule be met. The second requirement is that the distribution be made under one of a number of qualifying reasons. The "reasons" for a distribution that will result in a "qualified distribution" are listed here.

1. The accountholder has attained age 59 1/2.

2. The accountholder has died and the distribution(s) is being made to a beneficiary(s).

3. The accountholder has become permanently and totally disabled.

4. The accountholder takes a "qualified special purpose" distribution.

What is a "qualified special purpose" distribution? - A qualified special purpose distribution for the Roth IRA is the same first-time homebuyer exception we will have for regular IRAs in 1998. Note that for the Roth IRA, a distribution for education expenses is not a qualified distribution. The rules for the first-time homebuyer distribution are summarized in the article in the newsletter discussing the changes to the regular IRA.

Nonqualified Distributions

A nonqualified distribution is one that occurs before the five-year requirement has been met or one that is made for a reason other than one of those specified in the discussion of qualified distributions.

If a nonqualified distribution is made, possible income tax and penalties will be owed. Note the use of the word possible. In drafting the Code section relating to nonqualified distributions Congress made a completely unexpected and surprising rule. The rule for nonqualified distributions states that the distribution will be treated first as the distribution of contributions to the Roth IRA to the extent that the current distribution, when added to previous distributions, does not exceed the total contributions made by the individual to the Roth IRA.

This rule basically means that distributions from the Roth IRA, even nonqualified distributions, will not be subject to tax or penalties until such time as the person's basis, i.e. contributions to the IRA, is all distributed.

The unanswered question relating to this topic is whether or not all of a person's Roth IRA accounts are aggregated for this purpose. The Code does not make this clear.

Any portion of a nonqualified distribution that exceeds the accountholder's basis will be subject to income tax and a 10% premature distribution penalty tax if made prior to age 59 1/2.

REQUIRED DISTRIBUTIONS

The "70 1/2" required distribution rules for IRA accountholders do not apply to the Roth IRA. This means that no required distribution has to be made when the accountholder attains age 70 1/2.

Upon the death of the accountholder the required distribution rules for beneficiaries will apply. The question is, what options will a beneficiary have? The new Code does not specify which required distribution rules for

Continued on page 4

Eligibility for Regular IRA and Roth IRA Married Couple

Glenn's Compensation	Monica's Compensation	Combined AGI	Is Glenn Eligible Regular IRA?	Is Glenn Eligible Roth IRA?	Is Monica Eligible Regular IRA	Is Monica Eligible Roth IRA?
$45,000	$55,000	$100,000	Y	Y	Y	Y
-0-	250,000	250,000	Y	N	Y	N
30,000	30,000	60,000	Y	Y	Y	Y
100,000	30,000	130,000	Y	Y	Y	Y
-0-	148,000	148,000	Y	Y	Y	Y
40,000	110,000	150,000	Y	Y	Y	Y
40,000	115,000	155,000	Y	Y, only $1,000	Y	Y, only $1,000
130,000	28,000	158,000	Y	Y, only $400	Y	Y, only $400
130,000	30,000	160,000	Y	N	Y	N
130,000	130,000	260,000	Y	N	Y	N

Roth IRA—*Continued from page 3*

beneficiaries are applicable. It would seem to us that the options would be the same as a beneficiary would have for a regular IRA when the accountholder died before the required beginning date. In other words the five-year payout, the life-distribution option, and for a spouse beneficiary, the option to treat the IRA as their own. Watch for further guidance on this topic.

ROLLOVER RULES FOR THE ROTH IRA

There are two sets of rollover rules to examine for the Roth IRA. The first is a rollover from one Roth IRA to another Roth IRA. The second is a rollover from a regular IRA to a Roth IRA. Both sets of rules will be looked at in this material.

There can be no rollover from a QP/TSA plan to a Roth IRA.

Roth IRA to Roth IRA

The rules that govern this rollover are the same as for a rollover from one regular IRA to another regular IRA.

1. The accountholder is limited to one rollover distribution from a Roth IRA per 12-month period.

2. The check is made payable to the accountholder.

3. The funds must be redeposited within 60 days of receipt by the accountholder.

4. This transaction will be reported to the IRS. We do not yet know how this will be reported. The IRS will either have to revise the current Forms 5498 and 1099-R or devise new forms just for Roth IRA reporting.

5. Rollover documentation will be necessary. At this time it is unclear what the exact rollover documentation requirements will be. CWF will have the necessary rollover forms well before these rollovers can occur.

Regular IRA to Roth IRA Rollover

Certain individuals will be permitted to roll their regular IRA into a Roth IRA. This transaction will be a reportable event and will result in income taxes being owed.

1. Eligibility Requirements - In order to roll over regular IRA funds to a Roth IRA, the individual must have adjusted gross income of $100,000 or less in the year of the rollover. A married individual who files a separate tax return is not eligible to make this type of rollover.

2. The individual will have 60 days to complete the rollover.

3. The amount distributed from the regular IRA will be subject to income taxes. It will not be subject to any premature distribution penalty if it is rolled over within the 60-day period. If the rollover distribution is made before January 1, 1999, the amount that must be included in gross income will be included ratably over the four-taxable year period beginning with the year in which the distribution occurred. If the rollover occurs after January 1, 1999, the entire amount is included in gross income in the year of the distribution. Anyone who qualifies under the four-year period should experience a reduction in the income taxes owed. To utilize this rule, the distribution for rollover must occur in 1998.

4. A rollover from a regular IRA to a Roth IRA does not count towards the one-rollover-per-12-month rule.

5. This is a reportable transaction. Again, the IRS has not yet announced what the reporting requirements will be.

6. The rollover amount has a separate five-year requirement for "qualified distribution" purposes.

7. Rollover documentation will be necessary.

NOTE: The new legislation indicates that it is possible to "convert" a regular IRA to a Roth IRA. It appears this can be done by simply signing a new Roth IRA plan agreement and changing the title of the current account. Any conversion MUST be treated as distribution and a rollover contribution. This means it must be reported.

EXCESS CONTRIBUTIONS

The excess contribution rules for the Roth IRA are very similar to the excess rules for a regular IRA. The methods for correcting an excess to a Roth IRA are also similar to the rules for a regular IRA. If they remove the excess by the tax-filing deadline, with the earnings attributable to the excess, they will not owe the 6% excess contribution penalty. The earnings only will be taxable. If they do not correct the excess by the tax-filing deadline, they will owe the 6% penalty tax.

Also under this heading comes the possibility of a new transaction. The rules state that if an individual transfers a contribution made to a regular IRA for a tax year, along with its earnings, to a Roth IRA by the tax-filing deadline of the year for which the contribution was made, there will be no taxes owed. This assumes the individual did not claim a deduction for the regular IRA contribution. The basic thrust of this rule is that it permits an individual to "redesignate" a contribution to a regular IRA as a contribution to a Roth IRA.

ADMINISTRATION AND DOCUMENTATION

At the time of this writing, nothing is known regarding the IRA plan agreements for the Roth IRA. Additionally the IRS has yet to announce what any of the reporting requirements will be. As such, this material consists of our "best guess" as to what these requirements will be.

Roth IRA Plan Agreement

We anticipate the IRS will devise a new plan agreement just for the Roth IRA. It seems this is really their only option as the rules for the Roth IRA are too different to attempt to incorporate the regular IRA and the Roth IRA into one agreement. As soon as the plan agreement requirements are known, CWF will have custodial, trust, and self-directed versions of the plan agreement available.

Reporting

We anticipate a 5498 and a 1099-R for the Roth IRA. It is possible that the IRS will incorporate reporting for the Roth IRA into the current Forms 5498 and 1099-R. This would obviously mean fairly significant revisions to those forms. Alternatively, they may devise special forms just for the Roth IRA. At this time there is no way of knowing what the IRS will do.

We anticipate that the Roth IRA will prove to be one of the most popular savings vehicles to come along in a very long time. The tax benefits this account offers will be very attractive to many individuals. Prepare for a very busy 1998 IRA season! PD