THE Pension Digest

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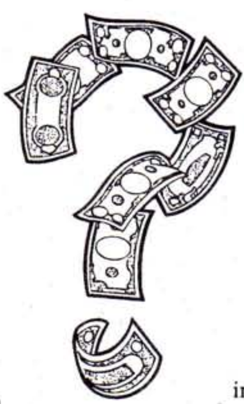
Analyzing Rollover Situations – To Roth or Not?

In 1998 and upcoming years, the question which many of you are going to receive from your existing "traditional IRA" accountholders and prospective clients is, "Should I withdraw all or a portion of the money I have in my traditional IRA and roll it over into a Roth IRA?" Determining an answer to this question will not be easy. Your clients (and their advisors) should consider a number of factors before deciding to make such a rollover. The purpose of this article is to discuss those factors and to present some examples.



Be assured, you will have clients, or prospective clients, who will wish to roll funds from their traditional IRA to a Roth IRA. You want to be ready to serve them.

We expect that many people who are over age 70 1/2 will wish to make this rollover. Why? The required minimum distribution rules do not apply to the Roth IRA. A Roth IRA accountholder will not be required to withdraw required minimum distributions from the Roth IRA as they must with their current traditional IRA.

Your institution wishes to be careful in handling these rollovers because your institution has a self-interest. You may well prefer to reduce your burden with respect to age 70 1/2 and older accountholders. You may also prefer to keep these long-term deposits rather than having to distribute them.

Therefore, if your client decides to make a rollover from his or her traditional IRA to a Roth IRA, you want to make it very clear that he or she has made the decision and has not relied upon your advice.

The following factors should be considered by every person who is contemplating making a rollover from a traditional IRA to a Roth IRA:

1. What marginal tax rate or rates will apply to the rollover distribution from the traditional IRA?

2. What marginal tax rates will apply to distributions from the traditional IRA if a rollover does not occur?

3. What amount or amounts will be distributed from the traditional IRA? Might this distribution be sufficiently large so that the distributee will move into a higher marginal tax bracket? The distributee could either be an accountholder or a beneficiary.

4. In what year or years will the distribution(s) take place? Distributions which occur in 1998 will qualify for the special rule mandating inclusion in income over four years.

5. What will the earnings rate be for the IRAs for various points in time? Will the earnings rate be more while working and less after the person has stopped working or at age 70 1/2, etc.

6. What likelihood is there that the investment might have an earnings rate much greater than the estimated 8%? A person who can foresee "substantial earnings" will want the investment held by a Roth IRA versus a traditional IRA. As you know, if certain rules are met, the earnings realized within the Roth IRA will never be taxed even when distributed.

7. How long will the funds be within the Roth IRA? The longer the funds are within the Roth IRA means the impact of the multiplier effect will be greater. The multiplier effect is—earnings will multiply or compound at a much greater rate if income taxes are not paid.

Continued on page 2

Technical Corrections Act of 1997

Traditional and Roth IRA Changes

There will be a number of "correcting" IRA law changes to the rules creating the Roth IRA and changes to the deduction rules for the regular or traditional IRA. The House Ways and Means Committee has already passed out of committee these changes. These changes will now be discussed in the full House and Senate.

It would be a great surprise if Congress does not pass the Technical Corrections Act of 1997. Most likely this bill will be passed during the first quarter of 1998. When passed, this bill will make the "corrections" retroactive to January 1, 1998.

Correction #1. Code section 219(g) will be corrected in two areas. Code section 219(g) contains the general rule that the $2,000 deduction limit for a contribution to the traditional IRA must be reduced when an individual or an individual's spouse is an active participant in an employer-sponsored retirement plan. This reduction shall not take place, however, for a spouse who is not an active participant if their modified gross income is less than $150,000. The gradual reduction will take place if the modified gross income is between $150,000 and $160,000.

This is a true technical correction. The result of the law as passed does not change, but the law is rewritten to assure the intended result. Note that a spouse who is not an active participant and who files a separate return will continue to

Continued on page 4

Also in this issue –

Rollover Situations—*Continued from page 1*

8. Will the five-year rule be met for sure with respect to the Roth IRA?

9. Does the IRA accountholder intend to withdraw funds from the IRA, or if he or she could, would the person not take any distributions because the IRA will be used to accumulate wealth and transfer it to children or other beneficiaries? Would the IRA accountholder take distributions from the IRA even if the law did not mandate such distributions at age 70 1/2? If so, when would these distributions take place? The accountholder will need to decide the specifics of timing and amount. For example, will only the RMD amount be withdrawn?

10. What is the likelihood that Congress might in the future decide to impose a tax on the "earnings" of the Roth IRA?

Analyzing whether or not to roll funds from a traditional IRA to a Roth IRA is complicated. Because of the space limitations of this newsletter we will discuss only one example.

Note that in order to compare a "rollover" with "not rolling over," the funds which are distributed from the traditional IRA (and taxed) are assumed to be reinvested, and the earnings related to the reinvestment will also be taxed. Obviously, such funds might be spent rather than reinvesting them.

The Example of Wendy Owens

Wendy celebrated her 70th birthday on February 10, 1998. She is married and she has designated her husband, Davis, as her sole beneficiary. He will also attain age 70 in 1998. She elects to use the one-year reduction method. On December 31, 1997, she had an IRA balance of $84,255. Her required distribution amount for 1998 is $4,255 ($84,255 ÷ 19.8). She is not eligible to roll over this $4,255 to a Roth IRA. She is eligible to roll over the remaining $80,000. She has no basis with respect to this IRA, so all distributions will be fully taxable.

Should she roll over the $80,000 to a Roth IRA? The answer primarily depends upon the tax rate which will apply to the two types of distributions. First, if she withdraws $80,000, then $20,000 must be included in income in 1998, 1999, 2000 and 2001. Second, what tax rate will apply to those distributions to come from the traditional IRA because of the RMD rules?

The following charts attempt to compare various results. The traditional column applies when there is no rollover. The Roth #1 column applies when the "net amount" is rolled over (i.e. gross distribution as reduced by taxes to be paid). The Roth #2 column applies when the entire $80,000 is rolled over because Wendy chose to roll over the full $80,000. To do this, she had to contribute the tax amount.

Observations

1. The accumulated value for Roth IRA #2 is always $372,876.57. One must keep in mind that a substantial portion of this accumulation is due to the additional contribution (i.e. the amount of the taxes).

For example, if the tax rate is 15%, then the amount of tax is $12,000. If Wendy chooses to contribute an additional $12,000 as the law permits her to do, then this $12,000 will accumulate to $55,391.49. Thus, $55,391.49 of the $372,876.57 arises from the $12,000 additional contribution and the remainder of $316,945.09 arises from the $68,000 ($80,000 - $12,000).

2. If the tax rate which applies to the "rollover distribution" or the nonrollover distributions will be the same percentage, then Wendy most likely should roll over the $80,000 to the Roth IRA. For example, the rates are both 15%, both 28%, both 31%, etc.

3. If the tax rate for the "rollover distribution" will be higher than the tax rates which will apply to the regular distributions from the traditional IRA, then Wendy most likely should not make the rollover. For example, a 28% rate would apply in 1998-2001, but only a 15% rate would apply to regular distributions from the traditional IRA.

4. If the tax rate for the "rollover distribution" will be lower than the tax rate which will apply to the regular distributions from the traditional IRA, then Wendy should make the rollover. For example, if a 15% rate would apply in 1998-2001, but a 28% rate would apply to regular distributions from the traditional IRA. PD

CHART #1 – Comparison of Accumulated Balances

	Traditional	Roth #1	Roth #2
If tax rate is 15%	$308,878.83	$316,945.09	$372,876.57
If tax rate is 28%	261,638.54	268,471.13	372,876.57
If tax rate is 31%	250,736.93	257,284.83	372,876.57
If tax rate is 36%	232,567.59	238,641.01	372,876.57
If tax rate is 39.6%	219,485.66	225,217.45	372,876.57

CHART #2 – Taxes to Be Paid and Present Value of Such Taxes

		Traditional	Roth #1	Roth #2
If tax rate is 15%	Actual	$54,508.03	$12,000.00	$12,000.00
	Present Value	21,006.94	10,731.00	10,731.00
If tax rate is 28%	Actual	78,115.66	22,400.00	22,400.00
	Present Value	31,060.25	20,032.00	20,032.00
If tax rate is 31%	Actual	83,563.56	24,800.00	24,800.00
	Present Value	33,380.24	22,178.00	22,178.00
If tax rate is 36%	Actual	92,643.41	28,800.00	28,800.00
	Present Value	37,246.89	25,755.00	25,755.00
If tax rate is 39.6%	Actual	99,180.90	31,680.00	31,680.00
	Present Value	40,030.89	28,331.00	28,331.00

IRS Releases Roth IRA Forms

The IRS has just issued Form 5305-R (Roth Individual Retirement Trust Account) and Form 5305-RA (Roth Individual Retirement Custodial Account). These two forms contain a creation date of January 1998.

A copy of the Form 5305-RA is reprinted herein. The principal features of this form are:

1. In the general instructions, the IRS makes the following statement:

> "This Roth IRA can be used by a grantor to hold: (1) IRA Conversion Contributions, amounts rolled over or transferred from another Roth IRA, and annual case contribution of up to $2,000 from the grantor; or (2) if designated as a Roth Conversion IRA (by checking the box on page 1), only IRA Conversion Contributions for the same tax year.
>
> To simply the identification of funds distributed from Roth IRAs, grantors are encouraged to maintain IRA Conversion Contributions for each tax year in a separate Roth IRA."

The IRS admits that a Roth IRA can receive one or more of the different types of contributions. However, the IRS encourages an IRA accountholder to maintain IRA conversion contributions for each tax year in a separate Roth IRA.

2. A Roth IRA will generally be one of two types. It will either be a Roth IRA which is not a Roth Conversion/Rollover IRA or it will be a Roth Conversion/Rollover IRA.

A Roth Conversion/Rollover IRA is a Roth that accepts only other Roth Conversion/Rollover contributions made during the same year. Note this restriction.

3. A married person who files a separate return is still eligible to make a Roth IRA contribution, but the permissible contribution amount is gradually phased out between adjusted gross income levels of $0 to $10,000.

This issue was not clear under the law as written. The Technical Corrections Bill clarifies this issue.

4. A box will be checked to indicate the Roth IRA is a Roth Conversion IRA. If so, the only permissible contributions are IRA conversion contributions made during the same tax year.

5. The Roth IRA custodian/trustee is not to accept IRA conversion contributions unless the depositor's AGI for the tax year is less than or equal to $100,000, and the depositor is required to file a joint income tax return.

6. The required distribution rules have a few surprises. These rules are not identical to the rules for the traditional IRA. Remember that there does not need to be "70 1/2" or older distributions from a Roth IRA, but distributions to beneficiaries are required after the depositor dies. But how and when?

If the surviving spouse is the sole beneficiary on the depositor's date of death, then the spouse will be treated as the Roth IRA accountholder. That is, this Roth IRA will become the IRA of the surviving spouse, but no election is required. This automatic conversion has the same effect as if the surviving spouse elected to treat the deceased spouse's IRA as his or her own.

If the surviving spouse is not the sole beneficiary, then each beneficiary of the Roth IRA (including a spouse beneficiary) will be required to withdraw minimum distributions according to the following rules. Each beneficiary will have the right to choose how he or she will comply with these rules unless the deceased accountholder has mandated a certain distribution method.

Option #1 is the standard five-year rule. All assets of the Roth inherited IRA must be distributed on or before December 31 of the year containing the fifth anniversary of the accountholder's death.

Option #2 is the life-distribution rule. As with the traditional IRA, the beneficiary must commence this method no later than December 31 of the year after the accountholder's death. However, there are no special rules for a spouse beneficiary who is not the sole beneficiary. The calculations to determine the life-expectancy factor will be: determine the age of the beneficiary as of the beneficiary's birthday in the year distributions are required to begin (i.e. the year after the year of death). This factor will be reduced by one for each succeeding year. The balance to be used in the calculation is the same — the entire interest in the inherited account as of the close of business on December 31 of the preceding year.

Note that for a spouse beneficiary you do not use the beneficiary's age in the year the accountholder would have reached age 70 1/2. The spouse beneficiary is also not permitted to elect to use the recalculation method. Note that you use the age of each beneficiary and not the age of just the oldest beneficiary.

7. In the instruction section of the form, the IRS does put the accountholder on notice when the 6% excise tax which applies to excess contributions could apply. They are: (i) if other contributions have been made to a traditional or Roth IRA; (ii) the accountholder's adjusted gross income exceeds the applicable limits and (iii) the accountholder and his or her spouse might have contributed more than their compensation.

Summary

The IRS has issued its model forms for the Roth IRA. Forms vendors should have their Roth forms available very shortly. You definitely are going to see both types of contributions into Roth IRAs — regular $2,000 contributions and rollover/conversion contributions.

IRS Releases Revised Traditional IRA Forms

The IRS has just issued the revised Form 5305 (Individual Retirement Trust Account) and Form 5305-A (Individual Retirement Custodial Account). The changes are very minimal and therefore the IRS has said that those IRA accountholders who are using the October 1992 version will not be required to use the January 1998 version. The IRS has not yet answered the question how long the 1992 version may continue to be used.

The fact that the IRA plan agreement does not need to change does not necessarily mean that the IRA disclosure statement should not be amended. For a detailed discussion of the necessity for furnishing IRA amendments, review the December 1996 newsletter.

There were only two changes to the traditional IRA forms. As you will recall, the last version was written in October of 1992. The rollover rules changed as of January 1, 1993. This meant that the form had to cover the pre-1993 rules and the post-1993 rules. The first change is that the references to the pre-1993 rules have been deleted. The second change is in Article III — the collectible language has been changed to allow investment in platinum coins and certain bullion. Remember that all of the rules relating to IRA deductions are not covered or discussed within the IRA plan agreement.

have to use the old rules because there was not a law change for this situation. There will be a gradual reduction when the modified adjusted gross income is between $0 and $10,000.

The remaining changes deal with the Roth IRA.

Correction #2. A basic design feature of the Roth IRA was that the contribution/eligibility limit was reduced on a pro rata basis if the taxpayer's adjusted gross income exceeded $150,000 with no reduction after $160,000. It was thought that a person, if married, was required to file a joint return to qualify for a Roth contribution. This is being changed to make it clear that a married person filing a separate return may also qualify for a Roth contribution, but the phase-out occurs between $0 and $10,000.

Correction #3. A basic design feature of the Roth IRA was that a five-year requirement had to be met if a distribution was to be a qualified distribution so that it would not be required to be included in income. There were two five-year periods. One five-year period applied if there was a "regular" contribution to a Roth IRA. This period commenced on January 1 of the first year that he or she (or his or her spouse) made such a contribution. Many analysts wondered how this "spousal connection" would be administered.

The second five-year period applied if there was a rollover contribution to a Roth IRA from a regular or traditional IRA. This period commenced on January 1 of the year in which the rollover contribution was made.

The new approach. A payment from a Roth IRA before the exclusion date will not be treated as a qualified distribution. There is one exclusion date for regular Roth contributions and a different one for rollover contributions.

The exclusion date for a regular Roth IRA contribution is the first day of the tax year occurring five years after the tax year for which the first regular Roth contribution was made. Note that the "spousal connection" has been eliminated.

The exclusion date for a Roth IRA which has received one or more rollover contributions from a traditional IRA (or from a Roth IRA which previously had received one or more rollover contributions from a traditional IRA) is the first day of the tax year occurring five years after the most recent taxable year for which any such rollover was made. That is, the making of additional rollover contributions to the same IRA will impose a new five-year requirement rather than being prohibited, or an excess contribution as originally enacted.

Corrections #4 to #7. These "corrections" are the primary reason for the Technical Corrections Bill.

Under the law as written, a person age 45 could roll over his or her traditional IRA to a Roth IRA in 1998. Such a rollover would not be subject to the 10% pre-age 59 1/2 excise tax. The person would also be able to use the special rules which allow him or her to include 25% of the distribution amount in income in 1998, 1999, 2000 and 2001. The person could then use the rule which allows a person to withdraw his or her "basis" first and withdraw his basis in 1998. In effect, he or she has avoided the 10% excise tax and has gained the tax benefit of "averaging" this income over four years.

The first new rule will provide that any distribution from a Roth Conversion IRA (i.e. allocable to a rollover from a traditional IRA) before the exclusion date (the five-year period) will be subject to the 10% penalty tax of Code section 72(t) unless one of the exceptions set forth therein would apply. That is, someone who is age 62 will be able to withdraw his or her basis from a Roth IRA and not be subject to the 10% excise tax.

A second new rule clarifies what happens if an accountholder who has used the four-year averaging rule with respect to a Roth conversion IRA dies before all such amounts are included in income. All remaining amounts shall be included in income for the year of death unless the surviving spouse is the sole beneficiary. The surviving spouse will have the right to elect to include such amounts in income over the remaining years just as the deceased spouse would have.

A third new rule will create a new 10% excise tax in addition to the other 10% excise tax created by section 72(t). The additional 10% tax will apply to any distribution from a Roth conversion IRA (i.e. allocable to a rollover from a traditional IRA) before the exclusion date (the five-year period) if four-year averaging was elected.

Corrections #8 and #10. These corrections deal with determining what portion of the distribution is taxable.

The existing law for traditional IRAs requires that in order to determine what portion of an IRA distribution is taxable, all traditional IRAs must be added together and treated as just one IRA, and all distributions during the tax year must be added together and be treated as one distribution.

TRA 97 created similar rules—except it was clear that all Roths would be added together and that all traditional IRAs would be added together. There was to be one calculation for traditional IRAs and another calculation for Roth IRAs.

The technical correction bill would create the following categories: (i) traditional IRAs; (ii) Roth IRAs composed of regular contributions; and (iii) conversion/rollover Roth IRAs with the same exclusion date. This means that rollovers occurring in different years will each have its own "basis" calculation.

The technical correction bill would also create an ordering rule for any distribution from a Roth IRA which was not a qualified distribution. Note that there is no change in the basic rule that the accountholder is allowed to withdraw his or her basis first. The ordering rule just defines from which IRA the withdrawal of the basis is treated as having taken place. The order: (i) non-rollover/conversion Roth IRAs; (ii) qualified rollover contributions which occurred in 1998; (iii) qualified rollover contributions which occurred in years after 1998; and (iv) other contributions not described in (ii) or (iii).

Correction #11. The rule allowing an excess contribution to a traditional IRA to be corrected before the tax-filing deadline by making a transfer to a Roth IRA has been clarified in a number of ways. First, the transfer may take place from a traditional IRA to a Roth IRA or from a Roth IRA to a traditional IRA. In order to make such a transfer, the earnings must be transferred, and no deduction must have been allowed. Note that the contribution is then deemed to have been made to the transferee IRA (versus the transferor plan to which the original contribution was made).

Correction #12. For purposes of applying the Roth rules, many times there are references to IRAs. Unless the IRS determines otherwise, the term "IRA" does not include SEP-IRAs and SIMPLE-IRAs.

Correction #13. A grammatical change was made with respect to the new extended rollover period for failed first-time home purchases, struck "120 days" and inserted "120th day."

Correction #14. Under existing law, the general rule is that all distributions from a qualified plan are eligible to be rolled over except two types—any required minimum distribution and any scheduled distribution of 10 or more years. A new type of nonqualifying distribution would be—a person who receives a hardship distribution could not roll over such a distribution. PD