



# THE Pension Digest

Published Since 1984

Collin W. Fritz and Associates, Inc., "The Pension Specialists"

December, 1997

## Discussion of Form 5305-RA, Roth Individual Retirement Account

The IRS has issued two model Roth IRA forms. The purpose of this article is to set forth and discuss the general instructions and the eight articles which comprise the IRS model Form 5305-RA.

### The General Instructions

The pertinent portion of the general instructions read as follows:

"This Roth IRA can be used by a depositor to hold: (1) IRA Conversion Contributions, amounts rolled over or transferred from another Roth IRA, and annual cash contributions of up to \$2,000 from the depositor, 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 simplify the identification of funds distributed from Roth IRAs, depositors are encouraged to maintain IRA Conversion Contributions for each tax year in a separate Roth IRA.

IRA Conversion Contributions. IRA Conversion Contributions are amounts rolled over, transferred or considered transferred from a nonRoth IRA to a Roth IRA. A nonRoth IRA is an IRA or IRA annuity described in section 408(a) or (b) other than a Roth IRA."

### CWF's Comments

1. The IRS has come up with a new term, "Roth Conversion IRA" which many people will find confusing. In a general sense, any money moved from a traditional IRA to a Roth IRA is a Roth conversion. The IRS, however, has come up with a more limited definition for the term, "Roth Conversion IRA." It means IRA Conversion Contributions made only for the same tax year. The IRS purpose is to "segregate" these funds (similar to a conduit IRA) within a separate Roth IRA so it will be easy to determine the tax results (i.e. the application of the five-year holding requirement and related rules) if

there is a distribution. Keep in mind that the Technical Corrections would generally impose two different 10% excise taxes if a person not yet age 59 1/2 would withdraw rolled over funds before the five-year requirement was met. Presumably, if a person combined rolled over contributions with regular Roth contributions and then he or she withdrew a portion, the amount withdrawn would be considered to primarily have come from the rollover and would be subject to the excise taxes.

2. Although the IRS recommends that rolled over funds be kept in a separate Roth IRA, the IRS acknowledges that a person may combine three types of contributions in a Roth IRA: (1) funds rolled over or transferred from a traditional IRA; (2) funds rolled over or transferred from another Roth IRA; and (3) annual cash contributions of \$2,000.

### Article 1

1. If this Roth IRA is not designated as a Roth Conversion IRA, then except in the case of a rollover contribution described in section 408A(e), the custodian will accept only cash contributions and only up to a maximum amount of \$2,000 for any tax year of the depositor.

2. If this Roth IRA is designated as a Roth Conversion IRA, no contributions other than IRA Conversion Contributions made during the same tax year will be accepted.

### CWF's Comments

1. The only type of Roth IRA which can accept the Roth annual contribution of \$2,000 is a Roth IRA which is not designated as a Roth Conversion IRA.

2. Only cash contributions may be made if a regular Roth contribution is being made, and then only to the extent of \$2,000. Note that there is no discussion in the plan agreement of when or how an excess contribution would be created. An

*Continued on page 2*

## IRS Provides Interim Guidance on Roth IRAs

The IRS issued Announcement 97-122 in Internal Revenue Bulletin 1997-50 on December 15, 1997. This Announcement provides interim guidance on Roth IRAs. That is, there will be more guidance forthcoming as the IRS has more time to address the numerous issues.

At the same time the IRS issued this Announcement, the IRS also issued the two model forms, Form 5305-R (trust version) and 5305-RA (custodial version). A discussion of the Form 5305-RA is set forth in a separate article in this newsletter.

### The Interim Guidance

(1) We (the IRS) have issued model forms. These forms serve as Service approved model forms for use by financial institutions to offer Roth IRAs to their customers.

Comment: most pension consulting companies, including CWF, base their IRA and Roth IRA plan agreements on the IRS model forms.

(2) Contributions to a Roth IRA must be maintained as a separate trust, custodial account or annuity from contributions to a traditional IRA. Separate accounting with-

*Continued on page 4*

### Also in this issue -

◆ The Roth IRA \$100,000 Rollover Requirement	Page 3
◆ Options Available to a Roth Beneficiary(ies)	Page 3
◆ ✓ Check It Out	Page 4

© 1997 Collin W. Fritz and Associates, Ltd.  
Copyright is not claimed in any material secured from official U.S. Government sources.  
Published by Collin W. Fritz and Associates, Ltd.  
Subscription Rate: \$65 per year.



excess could be created if the Roth IRA contribution would have already been made to another Roth IRA or if the person had made a contribution to a traditional IRA. Contributions to all traditional and Roth IRAs must be aggregated for purposes of the \$2,000 limit, and the law states that contributions are first considered made to the traditional IRA or IRAs.

3. A Roth Conversion IRA is one which accepts one or more rollover or conversion contributions from a traditional IRA during the same tax year. That is, there may be multiple rollovers, but they must occur all within the same tax year.

4. Note that there is no discussion of the tax consequences related to any contribution or distribution from a Roth IRA with this Roth IRA plan agreement.

### Article II

The \$2,000 limit described in Article I is gradually reduced to \$0 between certain levels of adjusted gross income (AGI). For a single depositor, the \$2,000 annual contribution is phased out between AGI of \$95,000 and \$100,000; for a married depositor who files jointly, between AGI of \$150,000 and \$160,000; and for a married depositor who files separately, between \$0 and \$10,000. In the case of a conversion, the custodian will not accept IRA Conversion Contributions in a tax year if the depositor's AGI for that tax year exceeds \$100,000 or if the depositor is married and files a separate return. Adjusted gross income is defined in section 408A(c)(3) and does not include IRA Conversion Contributions.

### CWF's Comments

1. The \$2,000 contribution limit is gradually reduced when one's AGI or one's combined AGI exceeds certain limits. The limits to be applied depend upon filing status: single; married filing jointly; and married filing separately.

2. There had been some thought that a married person who filed a separate return was not eligible to make a Roth IRA contribution. This form makes it clear that such a person is eligible, but he or she must use the phase-out range of \$0-\$10,000.

3. With respect to the \$100,000 AGI issue, the Form as drafted fails to put a person (or the trustee) on notice that "the depositor's AGI" means a married couple's combined AGI and not the specific depositor's AGI. Supposedly the IRS argues that the depositor's AGI for a person who files a separate return is found on the bottom of the Form 1040 and thus is the combined AGI. The IRS should rewrite its form as soon as possible.

### Article III

The depositor's interest in the balance in the custodial account is nonforfeitable.

### CWF's Comments

1. The identical provision is in the traditional IRA.

2. The "nonforfeitable" term connotes a special type of pension account with ultimate ownership in the IRA accountholder.

### Article IV

1. No part of the custodial funds may be invested in life insurance contracts, nor may the assets of the custodial account be commingled with other property except in a common trust or common investment fund (within the meaning of section 408(a)(5)).

2. No part of the custodial funds may be invested in collectibles (within the meaning of section 408(m)) except as otherwise permitted by section 408(m)(3), which provides an exception for certain gold, silver, and platinum coins, coins issued under the laws of any state, and certain bullion.

### CWF's Comments

1. There are two provisions. These provisions are the same as those within the traditional IRA.

2. The fact that Roth IRA funds cannot be invested in life insurance contracts does not mean that they cannot be invested in Roth IRA annuities.

3. Common trust funds could be established for Roth IRA funds. It is unclear if such common trust funds could encompass both traditional IRA funds and Roth IRA funds. The conservative approach would be to not combine both funds.

4. Roth funds may not be invested in collectibles; the same exceptions apply to the Roth IRA as to the traditional IRA—certain coins and bullion.

### Article V

1. If the depositor dies before his or her entire interest is distributed to him or her and the grantor's surviving spouse is not the sole beneficiary, the entire remaining interest will, at the election of the depositor or, if the depositor has not so elected, at the election of the beneficiary or beneficiaries, either:

(a) Be distributed by December 31 of the year containing the fifth anniversary of the depositor's death, or

(b) Be distributed over the life expectancy of the designated beneficiary starting no later than December 31 of the year following the year of the depositor's death.

If distributions do not begin by the date described in (b), distribution method (a) will apply.

2. In the case of distribution method 1(b) above, to determine the minimum annual payment for each year, divide the grantor's entire interest in the trust as of the close of business on December 31 of the preceding year by the life expectancy of the designated beneficiary using the attained age of the designated beneficiary as of the beneficiary's birthday in the year distributions are required to commence and subtract 1 for each subsequent year.

3. If the depositor's spouse is the sole beneficiary on the depositor's date of death, such spouse will then be treated as the depositor.

### CWF's Comments

1. This article explains what must happen after the Roth IRA accountholder dies.

2. If the depositor's spouse (current) is the sole beneficiary on the depositor's date of death, then this Roth IRA automatically is converted into the Roth IRA of the surviving spouse.

3. If the depositor's spouse is not the sole beneficiary, because either the spouse is not the beneficiary or because there are beneficiaries in addition to the spouse, the remaining balance in the Roth IRA will be distributed pursuant to either the five-year rule or the life-distribution rule. The depositor may specify which method a beneficiary must use, but if such instruction is not given, then each beneficiary may instruct which of the two methods will be used to distribute his or her required distributions. If the life-distribution rule is not elected by December 31 of the year following the year of death, then the five-year method is deemed elected.

The balance to be used in the life-distribution calculation is the entire interest in the Roth IRA as of the close of business on December 31 of the preceding year divided by the life-expectancy factor of the beneficiary using the age of the beneficiary as of his or her birthday in the year distributions are required to commence and subtracting one for each subsequent year. Note that there is no required distribution for the year of death. Any distribution in such year would be permissive and not mandatory.

### Article VI

1. The depositor agrees to provide the custodian with information necessary for the custodian to prepare any reports required under sections 408(i) and 408A(d)(3)(E), Regulations sections 1.408-5 and 1.408-6, and under guidance published by the Internal Revenue Service.

2. The custodian agrees to submit reports to the Internal Revenue Service and the depositor prescribed by the Internal Revenue Service.

### CWF's Comments

1. This language is identical to that within the traditional IRA form.

2. The depositor agrees to provide the information necessary so that the custodian/trustee may prepare any required forms and reports. This is an institution's basis of authority for obtaining a depositor's social security number rather than the Form W-9 or the backup withholding rules.

### Article VII

Notwithstanding any other articles which may be added or incorporated, the provisions of

*Continued on page 3*



Articles I through IV and this sentence will be controlling. Any additional articles that are not consistent with section 408A, the related regulations, and other published guidance will be invalid.

### CWF's Comments

1. This language is identical to that within the traditional IRA form.
2. This Article along with Article IX is the authority for an IRA custodian/trustee and depositor to agree to additional contractual terms. Such additional terms must not change the provisions of Articles I - IV and must be consistent with the Code, regulations and other published guidance on Roth IRAs.

### Article VIII

This agreement will be amended from time to time to comply with the provisions of the Code, related regulations, and other published guidance. Other amendments may be made with the consent of the persons whose signatures appear below.

### CWF's Comments

1. This language is identical to that within the traditional IRA form.
2. This Article establishes the basic authority for the fact that this Roth IRA plan agreement may be amended.

**Summary.** The provisions found within the Model IRS form are quite similar to those that are found in the traditional IRA. The main differences are: (1) Article II provides for reduction in the \$2,000 contribution limit depending upon certain AGI and filing status limitations; (2) Article II provides that a trustee may not accept a rollover contribution from a traditional IRA if the depositor's AGI exceeds \$100,000 or if a joint return is filed and (3) Article V provides for different required distribution rules.  $\square$

## Options Available to a Roth Beneficiary(ies)

The IRS in its model Roth forms has indicated what options will exist for the beneficiary of a Roth IRA. These options are different than those which apply for the traditional IRA.

The options which are available depend upon whether a spouse, if any, is or is not the sole beneficiary of the Roth IRA.

If the spouse is the sole beneficiary of his or her deceased spouse's Roth IRA, then that Roth IRA becomes the Roth IRA

*Continued on page 4*

# The Roth IRA \$100,000 Rollover Requirement

There is a great deal of confusion over the \$100,000 Roth rollover requirement. If a person is married, does the \$100,000 apply to his or her adjusted gross income (AGI) or does it apply to the couple's combined adjusted gross income? Obviously, the correct answer makes a very big difference.

Example: David and Roberta are married. David will have an adjusted gross income of \$75,000 in 1998 and Roberta will have an adjusted gross income of \$88,000. Each has a traditional IRA with a balance of \$25,000. If the \$100,000 limit is applied separately, each will be able to roll over the funds in his or her traditional IRA into a Roth IRA. If the \$100,000 limit is determined by using their combined adjusted gross incomes, then neither qualifies to make a rollover from their traditional IRA to a Roth IRA.

### What is the source of the confusion?

Code section 408A(c)(2)(B) reads as follows:

"(B) Rollover from IRA - A taxpayer shall not be allowed to make a qualified rollover contribution to a Roth IRA from an individual retirement plan other than a Roth IRA during any taxable year if -

- (i) the taxpayer's adjusted gross income for such taxable year exceeds \$100,000, or
- (ii) the taxpayer is a married individual filing a separate return."

This author believes subdivision (i) is quite clear. The limit applies to the one spouse who wishes to make the rollover and not to the AGI of both spouses.

The \$100,000 limit was not in the tax bill as passed by the House of Representatives. The Conference Committee imposed the \$100,000 limit. The Conference Committee Report contains the following statement, "Under the conference agreement, only taxpayers with AGI of less than \$100,000 are eligible to roll over or convert an IRA into a Roth IRA." This is the first source of confusion. The "married" situation is not expressly discussed.

The second and main source of confusion comes from the Joint Committee on Taxation Staff's General Explanation of Tax Legislation Enacted in 1997 (JCS-23-97), Issued Dec. 18, 1997. In tax industry jargon, the explanation is called the "bluebook." Under the section dealing with the conversion of an IRA to a Roth IRA, the

following statement is made, "Under the Act, only taxpayers with AGI of \$100,000 or less are eligible to convert an IRA into a Roth IRA. In the case of a married taxpayer, AGI is the combined AGI of the couple. Married taxpayers filing a separate return are not eligible to make a conversion." Editorial comment—it is quite interesting that the attorneys on the committee can write the explanation sufficiently well so that it is clear that combined AGI is used to determine if the \$100,000 limit is met, but they cannot write the statute in the same way. What is truly amazing is that the committee in its explanation seems to think that there doesn't even need to be a technical correction to assure their position that combined AGI must be used.

We have called the IRS to discuss this issue. The IRS has apparently adopted the position that the \$100,000 limit applies to the married couple's AGI and not to each spouse on a separate basis.

The problem is—the model forms which they wrote do not do a very good job of putting anyone on notice that the IRS believes the \$100,000 limit is a combined AGI limit.

The IRS issued its model Roth IRA forms in early December before the Committee had issued its explanation. The pertinent portion of Article II of Model Form 5305-RA reads as follows:

"In the case of a conversion, the custodian will not accept IRA Conversion Contributions in a tax year if the depositor's AGI for that tax year exceeds \$100,000 or if the depositor is married and files a separate return. Adjusted gross income is defined in section 408A(c)(3) and does not include IRA Conversion Contributions."

The way the IRS has written this form does not clearly put a person on notice that the \$100,000 limit is a married person's combined AGI and not just his or her own.

**Summary.** Taxpayers in this situation may well wish to wait to make his or her rollover until after this issue has been finalized more than it has been at this time. We believe the argument that the plain language of the statute should prevail so that the \$100,000 limit does not mean combined income. Congress can certainly pass a technical correction if they wish to impose the "combined limit."  $\square$



of the surviving spouse automatically. There is no election by the spouse to achieve this result, and the spouse may not elect any other option. It is unclear at this time how this conversion will be handled from a data processing standpoint. The surviving spouse should certainly designate his or her own beneficiaries as soon as possible. Although not mandatory, it probably will be desirable to have the surviving spouse sign a new Roth IRA plan agreement so that he or she can designate new beneficiaries.

If the spouse is not the sole beneficiary of his or her deceased spouse's Roth IRA, then each beneficiary will need to elect either the five-year rule or the life-distribution rule. The one-year reduction method will apply for purposes of the life-distribution rule for all beneficiaries, including a spouse, and each beneficiary will determine his or her own life-expectancy factor.

The pertinent provisions of the IRS model form are:

#### Article V

1. If the depositor dies before his or her entire interest is distributed to him or her and the grantor's surviving spouse is not the sole beneficiary, the entire remaining interest will, at the election of the depositor, or, if the depositor has not so elected, at the election of the beneficiary or beneficiaries, either:

(a) Be distributed by December 31 of the year containing the fifth anniversary of the depositor's death, or

(b) Be distributed over the life expectancy of the designated beneficiary starting no later than December 31 of the year following the year of the depositor's death.

If distributions do not begin by the date described in (b), distribution method (a) will apply.

2. In the case of distribution method 1.(b) above, to determine the minimum annual payment for each year, divide the grantor's entire interest in the trust as of the close of business on December 31 of the preceding year by the life expectancy of the designated beneficiary using the attained age of the designated beneficiary as of the beneficiary's birthday in the year distributions are required to commence and subtract 1 for each subsequent year.

3. If the depositor's spouse is the sole beneficiary on the depositor's date of death, such spouse will then be treated as the depositor.

Observation: A Roth IRA account holder may well wish to have separate Roth IRAs—one designating his or her spouse as the sole beneficiary and others for children or others as the designated beneficiary.  $\text{P}$

## ✓✓✓ Check It Out ✓✓✓

### Question: Can a Trailer Home Qualify as a Principal Residence?

✓ Answer: Yes.

Discussion. Code section 72(t) was amended to provide that in some situations the 10% excise tax will not apply to a distribution to an IRA account holder who is not yet age 59 1/2 if he or she uses the funds with respect to a first-time home purchase.

Code section 72(t)(8)(D) (ii) states that the term "principal residence" has the same meaning as used in section 121. Section 121 is the section which provides for the exclusion from taxation of a certain portion of the gain on the sale of the principal residence.

Regulation 1.121-3 states that the term "principal residence" has the same meaning as in section 1034 (relating to sale or exchange of residence) and the regulations thereunder. In general, Section 1034 provides for the deferral of the gain on a house which is sold as long as the new house being bought costs more than the house (principal residence) which was sold.

Regulation 1.1034-l(c)(3)(i) and (ii) read as follows:

(3) *Property used by the taxpayer as his principal residence.* (i) Whether or not property is used by the taxpayer as his residence, and whether or not property is used by the taxpayer as his principal residence (in the case of a taxpayer using more than

one property as a residence), depends upon all the facts and circumstances in each case, including the good faith of the taxpayer ... Property used by the taxpayer as his principal residence may include a houseboat, a house trailer, or stock held by a tenant-stockholder in a cooperative housing corporation (as those terms are defined in section 216(b)(1) and (2)), if the dwelling which the taxpayer is entitled to occupy as such stockholder is used by him as his principal residence (section 1034(f)). Property used by the taxpayer as his principal residence does not include personal property such as a piece of furniture, a radio, etc., which, in accordance with the applicable local law, is not a fixture.

Note that the above regulation is not very clear about whether or not the trailer home must qualify as real property or be a fixture under state law. The conservative answer is that it must be. However, it seems quite clear that in most situations the intent is clear that the trailer home serve as a person's principal residence.

Additional comment. Code section 217 provides that a taxpayer may deduct certain moving expenses. The rules revolve around a person changing his or her personal residence. This regulation too provides the rule that property such as a houseboat, house trailer or similar dwelling can be the taxpayer's principal residence, considering all of the facts and circumstances.  $\text{P}$

*The Pension Digest invites your questions and comments. Please address to "Check It Out," Collin W. Fritz & Associates, Ltd., P.O. Box 426, Brainerd, MN 56401.*

### IRS Guidance—Continued from page 1

in a single trust, custodial account or annuity is not permitted and will not qualify.

(3) The IRS is not presently accepting submissions for opinion letters on prototype Roth IRAs, but will issue procedures in the future for requesting such opinion letters.

(4) The IRS will permit a prototype sponsor to combine a Roth IRA and a traditional IRA in the same document provided that (1) the separate trust requirement is met and (2) the plan document as completed by the IRA applicant clearly indicates whether it is to be used as a traditional IRA or a Roth IRA. This must be done in such a way that makes it clear that designation as one type of IRA precludes its designation as a different type of IRA.

(5) The IRS will provide transitional relief to those financial institutions who do not use the pre-approved IRS model forms. Certain disclosures will need to be made once the IRS does approve the prototype.

(6) The IRS informs everyone that the House of Representatives has passed various technical corrections and therefore, Roth IRA account holders are instructed to maintain a separate Roth IRA to hold the amount rolled over from a traditional IRA from a Roth IRA containing regular Roth IRA contributions.  $\text{P}$