THE Pension Digest

Published Since 1984 Collin W. Fritz and Associates, Inc., *"The Pension Specialists"* May, 1998

The Tax Technical Corrections Act of 1998 is Near Passage

On May 7, 1998, the Senate finally passed a bill which includes various technical corrections to the Taxpayer Relief Act of 1997. These technical corrections are included within the IRS Restructuring and Reform Bill. The House of Representatives passed similar legislation in November of 1997. The Conference Committee will now meet to settle on the final contents of the bill. There are some differences between the two bills. We believe that technical corrections to the tax laws (and IRA laws) will be enacted within the next 60-90 days.

The purpose of this article is to give an overview of the technical corrections most likely to be enacted.

Except as specifically indicated below, these law changes would be retroactively effective as of January 1, 1998 (i.e. as if included in the 1997 Act and apply to taxable years beginning after December 31, 1997).

Rule Changes Regarding Conversion of Traditional IRAs Into Roth IRAs

1. Application of the four-year spread or averaging rule would be elective and not mandatory. If no election is made, then the four-year spread is deemed elected. The election would be irrevocable after the due date of the tax return for the year the conversion occurred.

2. Under current law a person receives the tax benefit of spreading the income realized from the distribution from the traditional IRA over four years. Congress believes there needs to be a recapture rule if a person withdraws funds from the Roth IRA before the four-year requirement has been met (i.e. 12-31-2001). The House rule provides for a simple 10% additional tax. In some situations under the House approach, the amount owed could be substantial. The Senate rule is not so simple, but it also is not so harsh. Under the Senate approach, the amount to be included in income for an early distribution during the four-year period would be the sum of (1) the amount otherwise includable in income under the four-year rule, and (2) the lesser of—the taxable portion of the withdrawal (and income comes out first) or the remaining taxable portion of the conversion. The following example has been provided by the joint staff:

"Example: Taxpayer A has a nondeductible IRA with a value of \$100 (and no other IRAs). The \$100 consists of \$75 of contributions and \$25 of earnings. A converts the IRA into a Roth IRA in 1998 and elects the 4-year spread. As a result of the conversion, \$25 is includible in income ratably over 4 years (\$6.25 per year). The 10-percent early withdrawal tax does not apply to the conversion. At the beginning of 1999, the value of the account is \$110, and A makes a withdrawal of \$10. Under the proposal, the withdrawal would be treated as attributable entirely to amounts that were includible in income due to the conversion. In the year of withdrawal, \$16.25 would be includible in income (the \$6.25 includible in the year of withdrawal under the 4-year rule, plus \$10 (\$10 is less than the remaining taxable amount of \$12.50 (\$25-\$12.50)). In the next year, \$2.50 would be includible in income under the 4-year rule. No amount would be includible in income in year 4 due to the conversion."

3. Current law does not contain a specific rule as to what happens if the individual who has made a Roth conversion dies during the four-year spread. The proposed law would be: all remaining amounts shall be included in the gross income of the decedent for the year of death. However, an exception is provided

Continued on page 2

Undoing a Roth Conversion - Easy or Not and Expensive or Not?

If the Technical Corrections bill is enacted into law, it will be easy and inexpensive to undo a Roth conversion.

As the law is currently written, there are some unanswered questions about the ability of a person who has made a Roth conversion/rollover to correct it or somehow "undo" it. There might be numerous reasons for wanting to "undo" it. The person finds out he or she is not eligible because their modified adjusted gross income exceeds the \$100,000 limit. The person determines that he or she did not understand as fully as they would have liked the taxes which have to be paid up front upon a Roth conversion.

There are two aspects to undoing a Roth conversion. The first aspect is to withdraw the money from the Roth. The discussion below will show that this is easy to do. The second aspect is to be able to permissibly return the money to a traditional IRA. The discussion below will show that there is some doubt that this can be done in some situations unless the technical corrections are enacted.

Continued on page 3

Also in this issue –

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

TCA 1998—*Continued from page 1*

for the surviving spouse. The spouse may elect to continue to use the same spread options which his or her deceased spouse would have used.

4. Under current law a person receives the tax benefit of not having to pay the 10% excise tax for a pre-59 1/2 distribution when he or she moves funds from a traditional IRA to a Roth IRA. He or she then could withdraw the principal and not owe any taxes. A person under age 59 1/2 has effectively taken a distribution from his or her traditional IRA and avoided the 10% excise tax. To prevent this, the law will be changed to impose the 10% excise tax on any distribution from a Roth IRA which occurs within the first five years, to the extent that the distribution is attributable to amounts that were includible in income due to the conversion and to which the 10% excise tax would have been applied except for the Roth conversion exception.

5. Under current law there are separate five-year "holding" requirements for regular Roth contributions and Roth rollover/conversion contributions. The bill would eliminate the separate rule and would be changed to a very simple rule—the five-year holding rule would commence with the first year for which any contribution to a Roth IRA is made. That is, subsequent contributions or conversions would not have a new five-year period.

Comment—If this rule is enacted, we would recommend that IRA custodians become quite aggressive in marketing the fact that every person should establish a Roth IRA (even of a minimal amount) so that the five-year period starts to run as soon as possible. The sooner it starts to run, the sooner the time period requirement will be met. For example, all potential first-time home buyers should have a Roth IRA.

6. There needs to be an ordering rule with respect to distributions from a Roth IRA. For taxation purposes, a person is considered to have only one Roth IRA even though he or she may actually have many Roth IRAs arising from regular Roth IRA contributions and from conversions in multiple years. The sequence of distributions would be: (a) regular Roth IRA contributions would come out first; (b) converted amounts would come out second (starting with the amounts first converted, and amounts converted which were taxable come out before any nontaxable converted amounts); and (c) earnings on any of the above come out last.

7. There are some people who are over age 70 1/2 who are not eligible to roll over/convert some or all of their traditional IRA funds because their required minimum distribution put them over the $100,000 limit. Effective for 2005 and subsequent years, any required minimum distribution would not count against the $100,000 limit.

8. It is made clear that a SIMPLE-IRA and a SEP-IRA cannot be designated as a SIMPLE Roth IRA or SEP Roth IRA.

9. Current law is not all that kind to a person who impermissibly rolls over or converts his or her traditional IRA to a Roth IRA. Actually the law is quite harsh. Another article discusses this subject.

The proposed law change regarding corrections is very favorable to the IRA or Roth IRA accountholder, as the person is allowed a simple way to correct for an erroneous rollover/conversion or to change the type of the IRA contribution (e.g. from a Roth IRA contribution to a traditional IRA contribution or vice versa).

However, these law changes will cause IRA custodians some administrative headaches. The IRA accountholder will have the right to instruct the IRA custodian that he or she wishes to transfer a previous contribution (and the related earnings) to a different type of IRA. This transfer can either be an internal transfer or an external transfer. For reporting purposes, the entity receiving the transfer is to report as if the original contribution had been made to its IRA. This is a type of retroactive contribution. Nice concept for tax purposes, but it will not be the easiest concept to be incorporated into IRA data processing systems. There needs to be a deemed contribution date which is different from the actual contribution date.

Rule Changes Regarding Limits Based Upon Modified Adjusted Gross Income

1. It would be made clear that a married person filing a separate return is eligible to make a Roth IRA contribution, but the contribution limit would be modified by using the range of income from $0-$10,000.

2. It would be made clear that an individual may contribute up to $2,000 a year to all of his or her traditional and Roth IRAs.

3. It would be made clear that the $150,000-$160,000 phaseout range applies to a married person filing a joint return if that person is not an active participant and that the phaseout range of $50,000-$60,000 (for 1998) applies to a married person who is an active participant.

Comment—The technical corrections bill does not clarify whether the $100,000 eligibility limit means a married person's adjusted gross income or his or her adjusted gross income as combined with his or her spouse's adjusted gross income. If they are clarifying the other rules, they should clarify this one also since it is obviously the most important.

Other Law Changes Regarding the Traditional IRA

1. Under current law, most distributions from qualified plans are eligible to be rolled over to a traditional IRA. Someone did not like the fact that under existing law a person could receive a hardship distribution from a 401(k) plan and yet roll the funds over to an IRA. The law change would make such distributions occurring after December 31, 1998, ineligible to be rolled over.

2. If the IRS levies against an IRA or pension account, the amount withdrawn is considered income to the person (and he or she must pay income tax on the distribution). If the person is not yet age 59 1/2 and no other exception applies, the person will owe the 10% excise tax. The law would be changed so that the 10% tax would not be owed. This would be a new exception to the assessment of the 10% excise tax. This change would be effective to levies made after the date of enactment.

Rule Changes Regarding Education IRAs

1. Although the legislative history is clear, a law change would make it law that there would be a deemed distribution from an Education IRA in two situations. First, there would be a deemed distribution date of 30 days after the beneficiary reaches age 30. Second, there would be a deemed distribution date of 30 days after the beneficiary dies.

2. The law would be clarified to require that the designated beneficiary must be a life-in-being.

3. The law would be clarified to make clear that the 10% excise tax would not be owed if an excess contribution is withdrawn before the due date of the beneficiary's tax return (plus extensions). If the beneficiary is not required to file a tax return, then the deadline is the following April 15.

4. Current law generally states that a 10% additional tax will be assessed if the distribution from the Education IRA must be included income. Normally, a distribution from an Education IRA is includible in income because it is not used to pay for qualified higher education expenses with-

Continued on page 3

TCA 1998—*Continued from page 2*

in the permissible limits. However, a distribution which is used to pay for education expenses will be subject to tax (and the 10% additional tax) if the taxpayer elects to claim HOPE or Lifetime Learning credit with respect to the beneficiary. The assessment of the 10% additional tax in this situation would be repealed, and it should be.

5. It would be made clear that the 6% excise tax which applies to an excess contribution to an Education IRA would apply for each year that an excess remains within the Education IRA, and not merely the year the excess is first made.

6. Since 1990, Code section 135 has allowed a taxpayer who pays qualified educational expenses for himself or herself, a spouse, or any dependent to exclude from his or her gross income any amount redeemed during such year from any qualified U.S. savings bond. The 1997 Act allows a taxpayer who redeems such U.S. savings bond to contribute these to an Education IRA or to a qualified State tuition program under Code section 529 versus actually paying the educational expenses, and still exclude the income for tax calculations. The definition of "eligible educational institution" as defined in Code section 135 would be revised to be defined the same as it is in Code section 529.

You should be aware that there is another bill in Congress right now which would make additional changes regarding Education IRAs. This tax bill would allow parents, corporations and others to make an annual contribution of up to $2,000. Rather than limiting withdrawals to being used just for higher education expenses, withdrawals for primary and secondary school expenses would also be permitted. We have chosen to not devote much discussion to this bill because President Clinton has said numerous times that he will veto it. Most likely, there are not sufficient votes to override his veto, as the bill only passed the Senate on a 56-43 vote.

Summary. Within the next 30-90 days, Congress and President Clinton should enact a technical corrections tax bill. Although there will be a few "new" rules, the primary purpose of this bill is to correct or clarify various IRA and tax provisions of the Taxpayer Relief Act of 1997.

Roth Conversion—*Continued from page 1*

The correction method contained in the technical corrections bill is very favorable for the Roth IRA accountholder, as the person is allowed a simple way to correct for an erroneous rollover/conversion or to change the type of the IRA contribution (e.g. from a Roth IRA contribution to a traditional IRA contribution or vice versa). "Erroneous" means any contribution the person wishes to not have made, for whatever reason.

The IRA accountholder will have the right to instruct the IRA custodian/ trustee or IRA annuity sponsor that he or she wishes to transfer a previous contribution (and the related earnings) to a different type of IRA. This transfer can either be an internal transfer or an external transfer. For reporting purposes, the entity receiving the transfer is to report as if the original contribution had been made to its IRA (be it traditional or Roth). This is a type of retroactive contribution. The only requirement is that the accountholder make this request to transfer on or before the tax-filing deadline for the "current" year plus extensions.

Discussion of Current Law (Without the Technical Corrections)

There is limited current law on this subject. It is found in Code section 408(d)(4) and Code section 408A(3)(D).

Code section 408(d)(4) allows a person to withdraw a current-year/excess contribution as long as three rules are met: (1) withdrawal must be on or before tax-filing deadline plus extensions; (2) the related earnings must be withdrawn; and (3) no tax deduction must have been allowed with respect to the contribution.

Code section 408A(3)(D) reads:

> (D) *Conversion of excess contributions.*— If, no later than the due date for filing the return of tax for any taxable year (without regard to extensions), an individual transfers, from an individual retirement plan (other than a Roth IRA), contributions for such taxable year (and any earnings allocable thereto) to a Roth IRA, no such amount shall be includible in gross income to the extent no deduction was allowed with respect to such amount.

It should be clear why the technical correction is necessary. As written, 408A(3)(D) allows one to transfer a contribution made to a traditional IRA to a Roth IRA, but not from a Roth IRA to a traditional IRA.

Step #1 - Withdrawing the Funds from the Roth IRA

A person may withdraw his or her Roth IRA contribution by using Code section 408(d)(4). Only the income earned while in the Roth IRA would be required to be included in income (i.e. taxable). The 10% excise tax would apply to this income portion, if applicable.

Remember that the person will at this point be required to pay income tax using the four-year spread because he or she withdrew the funds from the traditional IRA. The person may also be subject to the two new penalty taxes if he or she does not comply with the four and five-year holding requirements as proposed under the technical corrections.

Step #2 - Returning the Funds to the Traditional IRA

The current law is very murky concerning whether or not a person who has withdrawn funds from a traditional IRA and rolled or converted them to a Roth IRA can undo that rollover/conversion by withdrawing such funds and rolling them back into the traditional IRA. We have not seen the IRS discuss this subject. We believe the individual could. He or she, however, would have to comply with the 60-day rollover rule. If the 60-day period has expired, then the rollover method is not available to return the funds to a traditional IRA.

By returning the funds to the traditional IRA within the 60 days (i.e. a standard rollover), presumably the original distribution would no longer be taxable, and penalty taxes which apply to early withdrawals from a Roth IRA would also not apply.

Conclusion. You will have some customers who convert their traditional IRA to a Roth IRA and then later decide they could not or should not have done so. Most likely the technical corrections bill will provide them an easy way to undo the Roth conversion. Any person who wishes to undo their Roth conversion will need to decide between using the standard rollover rules, if available, or waiting for the technical corrections to become law. We believe the more conservative approach is to wait until the technical corrections become law and then make the correcting transfer from the Roth IRA back to the traditional IRA.

1997 Form 5498 SEP Reporting

It appears from recent consulting calls that there is a good deal of confusion regarding the proper reporting of SEP contributions on the 1997 Form 5498. Most IRA software is written so one can identify for what tax year a contribution is made. This is certainly needed for IRS reporting purposes for IRAs. It is also desired from a customer service standpoint, but no longer needed for purposes of preparing "required" reports to the IRS for SEP-IRAs and SIMPLE-IRAs.

An IRA custodian must report SEP contributions on the 1997 Form 5498 and will be required to report SEP contributions for future years. The IRS' 1997 instructions for box 6, SEP Contributions, are very brief as they read, "Shows the SEP contributions made <u>in</u> 1997. If made by your employer do not deduct on your tax return. If you made the contributions as a self-employed person (or partner) they may be deductible. See Pub. 560."

I have underlined the word "in." The word is not "for." Unfortunately, the IRS does not offer any additional explanation or illustration.

"In" means in. You must insert in box 6 those SEP contributions made in 1997 (i.e. those made from January 1, 1997, to December 31, 1997) whether made for tax year 1996 or 1997. Any 1997 SEP contributions made in 1998 will be reported on the 1998 Form 5498 along with any 1998 contributions made before December 31, 1998.

Our "educated" guess for this approach by the IRS is that the IRS understands that it is impossible for a bank to furnish, on a timely basis, information on SEP contributions on a tax-year basis since the law provides that SEP contributions may be made by the employer later than April 15 (or even the Form 5498 filing deadline of May 31) if the contributing employer has a valid tax extension. The best information the IRS can get is "aggregate information" which can be reviewed in conjunction with the taxpayer's claimed tax deductions for two to three years to see if a persons' tax return is being prepared correctly. Also, an employer can establish a SEP on a fiscal-year basis, and this makes reporting SEP contributions on the Form 5498 and a certain tax year impossible. The IRS understands this.

An IRA custodian may find it desirable to furnish a written explanation to its customers. Your customers may also expect that box 6 of the Form 5498 will show their SEP contributions for tax year 1997, and this is not the case. You may wish to answer a potential questions before it is asked. PD

Tax Issues Related to Death of a Roth Conversion IRA Accountholder

In this article we will discuss two separate times when taxes could be owing due to the death of a Roth Conversion IRA accountholder. Both situations occur if the accountholder dies within the first five years of establishing the account. The first instance is the payment of taxes on the original rollover amount, and the second instance is the taxes owed on the distributions made to the beneficiaries.

If a rollover from a traditional IRA to a Roth Conversion IRA occurs during 1998, the distribution is taxable over the four-year period beginning in 1998. For example, Troy Michael rolled over a $40,000 IRA distribution to a Roth Conversion IRA on March 10, 1998. The amount of $10,000 will be includable in Troy's gross income in each tax year—1998, 1999, 2000 and 2001.

Let's assume Troy dies on April 11, 1999. Troy paid the taxes on the first $10,000 for 1998. Who pays the taxes on the remaining $30,000?

Troy's personal representative would include the remaining amount in Troy's gross income for the taxable year that includes the date of his death. In other words, the final income tax return of Troy Michael would pay the taxes by including the entire remaining $30,000 in Troy's gross income for 1999. If elected, the surviving spouse and the personal representative may agree to file a joint return. Or, the representative of Troy Michael may file—married filing separately.

If the spouse is the only beneficiary of a Roth Conversion IRA, there is an additional option. In our example, Troy's wife may include the remaining amount in her gross income in the same taxable years as Troy would have, had he lived. She could include $10,000 in her gross income for tax years 1999, 2000 and 2001 which could result in a reduction to the income taxes owed.

Now that we have discussed the taxation of the original rollover amount, let's discuss the beneficiary issues.

If Troy's spouse was the only beneficiary, she would automatically become the owner of the Roth IRA. She should now designate her own beneficiaries, and she has complete control of when, or if, withdrawals take place during her lifetime.

If the primary beneficiaries of Troy's account were his wife and three sons, all four beneficiaries would have two options. They could either withdraw the funds over a five-year payout, or they could choose a life-distribution schedule.

- The five-year payout means that the Roth IRA must be withdrawn entirely by December 31 of the year that contains the fifth anniversary of the accountholder's death. In our example, the plan would have to be closed by 12-31-2004.
- The life-distribution method is based on the single life expectancy of each beneficiary, reduced by one for each year. This option must be commenced no later than December 31 of the year after the accountholder's death. Therefore, in our example, the wife and each of the three sons would have a different payout schedule based on their individual life expectancy, and would need to start the distributions by December 31, 2000.

What are the tax consequences of the distributions that the beneficiaries receive?

In order for there to be a "tax- free" distribution, the 5-year rule must be met, and in addition, the withdrawal must be made for one of the four "qualifying" reasons. Death is a qualifying reason, but for the distribution to be tax-free, the beneficiaries are still required to complete the five-year period that the accountholder had started. Because Troy opened his Roth IRA in 1998, the five-year time period will not be completed until January 1, 2003.

The beneficiaries can withdraw the basis or rollover contribution of $40,000 without the imposition of ordinary income tax. However, if they withdraw the entire plan before the five-year period is completed, the interest that has been withdrawn would be taxable. If they wait to withdraw the interest until after January 1, 2003, it can be withdrawn tax free. PD