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IRS Issues Proposed Roth IRA Regulations

The IRS has issued a proposed regulation on Roth IRAs. This is regulation 1.408A. This additional guidance is welcomed. The purpose of this article is to present you with the most recent IRS' insights about Roth IRAs. A few may surprise you.

1. The four-year spread option is available to a person who receives the conversion amount in late 1998 but waits until 1999 to contribute the funds to a Roth IRA as long as the 60-day rollover rule is met.

2. A Roth conversion is not available to a person who received a distribution in late 1997 and then tried to deposit it into a Roth IRA in 1998. If someone attempted this, he or she could correct the error by using the withdrawal of excess contribution rules.

3. There are three ways to accomplish a conversion from a traditional IRA to a Roth IRA.

Method #1. An amount distributed from a traditional IRA is contributed (i.e. rolled over) to a Roth IRA within 60 days of the distribution.

Method #2. An amount in a traditional IRA is transferred to a Roth IRA maintained by the same custodian or trustee.

Method #3. An amount in a traditional IRA is transferred in a custodian/trustee-to-custodian/trustee transfer from the custodian/trustee of the traditional IRA to the custodian/trustee of the Roth IRA.

Whatever conversion method is used, the custodian/trustee of the traditional IRA will prepare a Form 1099-R to report the distribution and the custodian/trustee of the Roth IRA will prepare a 5498 to report the conversion contribution.

Method #3 is somewhat surprising as the IRS is starting to be inconsistent in their use of certain terms. In the past a trustee-to-trustee transfer could occur only if the remitting plan and the receiving plan were identical. They are not identical in a conversion situation. In addition, a transfer has always meant that there would be no need to report the transaction. In this Roth conversion situation, a transfer is reportable.

4. In order to be eligible to make a Roth conversion, an individual must have $100,000 or less of modified adjusted gross income. If the individual is married, then the combined modified adjusted gross income is still limited to $100,000. Modified adjusted gross means the individual's adjusted gross income minus the amount of any conversion. An individual's adjusted gross income is that definition of income which is used to determine the amount of his or her deductible contribution to a traditional IRA. Under this definition the individual is not allowed to reduce his or her income by the amount of the deductible traditional IRA contribution. This means an individual cannot make a contribution to a traditional IRA and claim a deduction to it so that his or her modified adjusted gross income will be reduced to less than $100,000.

5. A person's modified adjusted gross income can be so high that he or she will not be eligible to make a Roth IRA contribution or will be eligible to make only a partial contribution. There are three income ranges depending upon one's filing status. These are set forth below. For the purposes of these limits, a married person who has lived apart from his or her spouse for the entire tax year and who files a separate return is treated as not married. This person gains the benefit of the $95,000 - $110,000 range rather than the $0 - $10,000 range. The ranges:

Married, Joint Return	$150,000	-	$160,000
Married, Separate Return	$0	-	$10,000
Not Married	$95,000	-	$110,000

6. An attempt to accomplish a Roth conversion which does not qualify (i.e. fails) will result in some harsh tax consequences unless corrected in a timely fashion under the withdrawal of excess contribution

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Withholding and Roth IRAs

The withholding rules of Code section 3405 do apply to distributions from Roth IRAs. The same rules which apply to distributions from traditional IRAs apply to distributions from Roth IRAs. An individual can elect to have no amount withheld.

The withholding rules also apply to a conversion from a traditional IRA to a Roth IRA. As you will recall, there are three methods which can be used to accomplish the conversion - rollover, external transfer and internal transfer. There is a special rule for 1998 conversions which occur either by an external or internal transfer. No withholding is required even though the individual elected to have no withholding. Note this special rule applies only to the two types of conversions occurring in 1998. Any conversion occurring in 1999 will have to comply with the withholding rules. PD

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rules or recharacterization rules. For example, a 45 year old person attempts to convert $77,000 even though his modified adjusted gross income is $104,000. This $77,000 contribution is treated as a regular $2,000 contribution and an excess contribution of $75,000. The excess contribution is subject to the 6% excise tax. Because there has not been a qualifying conversion, he would have to include the entire $77,000 in his income, he does not qualify for the 4-year spread option and the 10% additional tax would apply unless an exception would apply. The Roth conversion exception does not apply as there has not been a qualifying Roth conversion.

7. An amount in a person's SEP IRA is eligible to be converted to a Roth IRA.

8. An amount in a person's SIMPLE-IRA is eligible to be converted to a Roth IRA only if the two-year holding requirement has been met. The IRS' rationale - since a person qualifies to roll over or transfer funds from a SIMPLE-IRA to a traditional IRA only if the two-year requirement has been met, then the same rule applies to move funds from a SIMPLE-IRA to a Roth IRA.

9. A person cannot convert funds in a qualified plan, tax-sheltered annuity, section 457 plan or any other plan to a Roth IRA.

10. A person who will attain age 70 1/2 or older in 1998 should be paid his or her required distribution before converting any funds in a traditional IRA to a Roth IRA. The reason: under the RMD rules, the first dollars distributed from the traditional IRA are considered to be required distributions until an amount equal to the required minimum distribution amount has been distributed.

If a person converts all or a portion of his or her traditional IRA before satisfying the RMD amount, then the person will have some adverse tax consequences. For example, a 75 year old person attempts to convert $77,000 when he had not yet been distributed his RMD amount of $5,000. The first $5,000 is treated as a regular Roth contribution. There is an excess contribution of $3,000, as long as he was eligible to make a regular $2,000 Roth contribution, and the 6% excise tax will be owed unless corrected. The remaining $72,000 will qualify to be converted. Only the amount of $72,000 would qualify for the four-year spread option.

11. A person who makes a conversion will have to include the distribution amount in income for all purposes except it is disregarded for purposes of determining modified adjusted gross income for section 408A.

The IRS gave two examples. First, the distribution is income for purposes of determining the taxable portion of social security payments under section 86. This is true even if the four-year spread method is elected. Second, the conversion amount is considered income for purposes of determining the phaseout of the $25,000 exemption under section 469(i) relating to the disallowance of passive activity losses for rental real estate activities.

12. After the technical corrections bill, the person has the choice of using either the four-year spread option or including the entire distribution in income in one year. The person must affirmatively elect the all-in-one-year option by completing the Form 8606. This election cannot be made or changed after the due date (including extensions) for filing the 1998 Federal income tax return.

13. A surviving spouse beneficiary can elect to continue the four-year spread option on either the Form 8606 or the Form 1040 for the tax year which includes the deceased Roth IRA accountholder's death.

14. Even though a person is taking substantially equal periodic payments from an IRA so that the 10% additional tax of Code section 72(t) does not apply, this person may still convert his or her traditional IRA to a Roth IRA without being subject to the recapture tax. However, the distribution schedule must continue from the Roth IRA in accordance with the rules. If not, the recapture tax will apply. PD

Taxation of Roth Distributions

1. A distribution from a Roth IRA is not includible in the owner's gross income if it is a qualified distribution. A qualified distribution is one that is both—

a. Made after a five-taxable year period; and

b. Made on account of one of the following four reasons:

(1) made on or after the date on which the owner attains age 59 1/2;

(2) made to a beneficiary or the estate of the owner on or after the date of the owner's death;

(3) attributable to the owner's being disabled within the meaning of section 72(m)(7); or

(4) used for a first-time home purchase within the meaning of section 72(t)(2)(F)

2. After the technical corrections bill, there no longer is maintained a five-year period for annual contributions and another five-year period for conversion contributions. There is now just one five-year period. The five-year period begins on the first day of the person's taxable year for which the first regular/annual contribution is made to any Roth IRA or, if earlier, the first day of the person's taxable year in which the first conversion contribution is made to any Roth IRA of that person. Because of the five-year requirement, there cannot be a qualified distribution from a Roth IRA until 2003.

However, as discussed later, there is a separate 5-year period for inherited Roth IRAs.

3. Except for the exception discussed below, the death of a Roth IRA owner does not require a recalculation of the five-year period. This is true even if a spouse beneficiary elects to treat the decedent's Roth IRA as his or her own. This means a person who inherits a Roth IRA will most likely have a separate five-year period for the inherited Roth IRA versus any Roth IRAs which he or she has established for himself or herself.

The exception is a "be kind to spouse" rule. A spouse beneficiary who elects the deceased spouse's Roth IRA as his or her own will determine just one five-year calculation. His or her five-year period will end on the earlier of the five-year period which applied for the decedent or the five-year period which applies to the surviving spouse's own Roth IRAs.

4. A distribution from a Roth IRA is not includible in the owner's gross income even if it is not a qualified distribution to the extent that the distribution, when added to the amount of all previous distributions (whether or not they were qualified distributions from the owner's Roth IRA) exceeds the owner's contributions to all of his or her Roth IRAs.

5. A distribution from a Roth IRA is not includible in the owner's gross income even if it is not a qualified distribution if it is rolled over to another Roth IRA.

6. A distribution from a Roth IRA is not includible in the owner's gross income, even if it is not a qualified distribution, if it involves the withdrawal of an excess contribution in accordance with section 408(d)(4). The return of the contribution is not required to be included in income, but the related income must be for the year in which the excess contribution was made.

7. A distribution from a Roth IRA can be comprised of one or more of the following: regular contributions, conversion contributions or earnings.

The law mandates the following order for distributions: (1) from regular/annual contributions; (2) from conversion contributions on a first-in-first-out basis and (3) from earnings. The order is determined as of the end of the taxable year, and each category must be exhausted before the next is used. With respect to a conversion contribution, it is treated as being made first from the portion, if any, that was includible in gross income as a result of the conversion.

To aid in administering this ordering, the IRS has created the following rules.

a. All distributions from all of an individual's Roth IRAs made during a taxable year are aggregated. There are two exceptions.

First, a distribution which is rolled over to another Roth IRA is disregarded.

Second, a distribution of an excess contribution along with the net income is disregarded.

b. All regular/annual contributions made for the same taxable year to all of the individual's Roth IRAs are aggregated and added to the undistributed total of regular/annual contributions for prior years. Note that there are two exceptions.

First, a rollover contribution from another Roth IRA is disregarded.

Second, the making of an excess contribution is disregarded if it is corrected in accordance with the rules.

There is also a special rule arising from the recharacterization rules. If an individual recharacterizes a contribution made to a traditional IRA by transferring it to a Roth IRA, the contribution to the Roth IRA is taken into account. It is treated as contributed to the Roth IRA on the same date and for the same taxable year that the contribution was made to the traditional IRA.

c. All conversion contributions received during the same tax year by all of the individual's Roth IRAs are aggregated. Thus, if there are two conversion contributions in 1998 and three in 1999, then the two 1998 conversion contributions will be aggregated, as will the 1999 conversion contributions. However, there is a special rule. The conversion contributions received in 1999 must be segregated into two types. Type one is comprised of those Roth conversion contributions withdrawn in 1998 but recontributed in 1999 and with respect to which the 4-year spread method was selected. Type two is comprised of all other Roth conversions contributed in 1999.

There are three special rules.

First, a rollover contribution from another Roth IRA is disregarded.

Second, the making of an excess contribution is disregarded if it is corrected in accordance with the rules.

There is also a special rule arising from the recharacterization rules. If an individual recharacterizes a regular or a conversion contribution made to a Roth IRA by transferring it to a traditional IRA, then the original contribution to the Roth IRA and the recharacterizing transfer are disregarded in determining the amount of both contributions and distributions for the Roth IRA.

8. If the Roth IRA accountholder dies before the five-year requirement has been satisfied, then a portion of any distribution may be required to be included in income. If there are multiple beneficiaries, there must be a method to allocate the different types of contributions to the beneficiaries. The method to be used is a pro rata method. Assume the following: a Roth IRA accountholder dies in 1999; the Roth IRA contains regular/annual contributions of $4,000; a conversion contribution of $20,000 and earnings of $2,000; beneficiary #1 is to receive 50%, beneficiary #2 is to receive 30% and beneficiary #3 is to receive 20%; and beneficiary #3 is distributed $3,000. The share for beneficiary #3 is $5,200 allocated as follows: $800 ($4,000 x 20%) of regular contributions; $4,000 ($20,000 x 20%) of conversion contributions; and $400 ($2,000 x 20%) of earnings. Of the $3,000 withdrawn, $800 is allocated to regular contributions and the remainder of $2,200 is allocated to conversion contributions.

9. The 10% additional tax of Code section 72(t) applies to that portion of a distribution from a Roth IRA which is includible in gross income unless an exception applies.

10. The technical corrections law provided for two recapture taxes. A recapture tax is generally assessed when a taxpayer takes advantage of a favorable tax rule, but fails to comply with a time requirement. The first recapture tax is discussed below in section 11. The second recapture tax is discussed below in section 12.

11. The 10% additional tax of Code section 72 (t) also applies even if the distribution from the Roth IRA is not includible in gross income if the distribution is allocable to a conversion contribution which is withdrawn before a five-year requirement is met.

Note that for the purpose of this additional 10% tax, there is a separate five-year requirement for each conversion contribution. This five-year period begins on the first day of the individual's tax year (normally January 1) in which the conversion contribution is made. This five-year period ends on the last day of the individual's fifth consecutive taxable year beginning with the taxable year described in the preceding sentence (normally this is December 31).

This five-year requirement for the purpose of this additional 10% tax need not be the same period as the five-year period calculated to determine if the distribution is a qualified distribution for purposes of determining if the income will not be taxed. For example, Jane Doe, a calendar year taxpayer, withdraws $10,000 from her traditional IRA on December 30, 1998. She makes a conversion contribution on February 24, 1999, by contributing the distributed amount to a Roth IRA in a qualifying rollover contribution and simultaneously makes a regular Roth contribution for 1998. For purposes of assessing the 10% additional tax, the five-year period commences on 1-1-99, whereas the five-year period for purposes of determining if the income will be excluded is 1-1-98.

This additional 10% tax applies only to the amount of the conversion which is includible in gross income as a result of the conversion and then, only if none of the exceptions of Code section 72(t) apply.

12. There is also a recapture situation if a taxpayer or surviving spouse elects to use the four-year spread option for his or her 1998 conversion contribution, but then chooses to take a distribution before 2001.

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The concept is: this taxpayer should not receive the full benefit of the four-year spread if he or she takes an early distribution.

Any income deferred to 1999-2201 is accelerated so that it is includible in gross income in the year of distribution up to the amount allocable to the 1998 conversion.

This accelerated amount is in addition to the amount otherwise includible in the person's gross income under the four-year spread rule. The amount accelerated will never exceed the total amount of income required to be included over the four-year period.

13. The following examples from the proposed regulations illustrate these ordering rules:

*"**Example 1.** In 1998, individual B converts $80,000 in his traditional IRA to a Roth IRA. B has a basis of $20,000 in the conversion amount and so must include the remaining $60,000 in gross income. He decides to spread the $60,000 income by including $15,000 in each of the 4 years 1998-2001, under the rules of §1.408A-4 A-8. B also makes a regular contribution of $2,000 in 1998. If a distribution of $2,000 is made to B anytime in 1998, it will be treated as made entirely from the regular contributions, so there will be no Federal income tax consequences as a result of the distribution.*

***Example 2.** The facts are the same as in Example 1, except that the distribution made in 1998 is $5,000. The distribution is treated as made from $2,000 of regular contributions and $3,000 of conversion contributions that were includible in gross income. As a result, B must include $18,000 in gross income for 1998: $3,000 as a result of the acceleration of amounts that otherwise would have been included in later years under the 4-year spread rule and $15,000 includible under the regular 4-year spread rule. In addition, because the $3,000 is allocable to a conversion made within the previous 5 taxable years, the 10-percent additional tax under section 72(t) would apply to this $3,000 distribution as if it were includible in gross income for 1998, unless an exception applies. Under the 4-year spread rule, B would now include in gross income $15,000 for 1999 and 2000, but only $12,000 for 2001, because of the accelerated inclusion of the $3,000 distribution.*

***Example 3.** The facts are the same as in Example 1, except that B makes an additional $2,000 regular contribution in 1999 and he does not take a distribution in 1998. In 1999, the entire balance in the account, $90,000 ($84,000 of contributions and $6,000 of earnings), is distributed to B. The distribution is treated as made from $4,000 of regular contributions, $60,000 of conversion contributions that were includible in gross income, $20,000 of conversion contributions that were not includuble in gross income, and $6,000 of earnings. Because a distribution has been made within the 4-year spread period, B must accelerate the income inclusion under the 4-year spread rule and must include in gross income the $45,000 remaining under the 4-year spread rule in addition to the $6,000 of earnings. Because $60,000 of the distribution is allocable to a conversion made within the previous 5 taxable years, it is subject to the 10-percent additional tax under section 72(t) as if it were includible in gross income for 1999, unless an exception applies. The $6,000 allocable to earnings would be subject to the tax under section 72(t), unless an exception applies. Under the 4-year spread rule, no amount would be includible in gross income for 2000 or 2001 because the entire amount of the conversion that was includible in gross income has already been included.*

***Example 4.** The facts are the same as in Example 1, except that B also makes a $2,000 regular contribution in each year, 1999 through 2002, and he does not take a distribution in 1998. A distribution of $85,000 is made to B in 2002. The distribution is treated as made from the $10,000 of regular contributions (the total regular contributions made in the years 1998-2002), $60,000 of conversion contributions that were includible in gross income, and $15,000 of conversion contributions that were not includible in gross income. As a result, no amount of the distribution is includible in gross income; however, because the distribution is allocable to a conversion made within the previous 5 years, the $60,000 is subject to the 10-percent additional tax under section 72(t) as if it were includible in gross income for 2002, unless an exception applies.*

***Example 5.** The facts are the same as in Example 4, except no distribution occurs in 2002. In 2003, the entire balance in the account, $170,000 ($90,000 of contributions and $80,000 of earnings), is distributed to B. The distribution is treated as made from $10,000 of regular contributions, $60,000 of conversion contributions that were includible in gross income, $20,000 of conversion contributions that were not includible in gross income, and $80,000 of earnings. As a result, for 2003, B must include in gross income the $80,000 allocable to earnings, unless the distribution is a qualified distribution; and if it is not a qualified distribution, the $80,000 would be subject to the 10-percent additional tax under section 72(t), unless an exception applies.*

***Example 6.** Individual C converts $20,000 to a Roth IRA in 1998 and $15,000 (in which amount C had a basis of $2,000) to another Roth IRA in 1999. No other contributions are made. In 2003, a $30,000 distribution, that is not a qualified distribution, is made to C. The distribution is treated as made from $20,000 of the 1998 conversion contribution and $10,000 of the 1999 conversion contribution that was includible in gross income. As a result, for 2003, no amount is includible in gross income; however, because $10,000 is allocable to a conversion contribution made within the previous 5 taxable years, that amount is subject to the 10-percent additional tax under section 72(t) as if the amount were includible in gross income for 2003, unless an exception applies. The result would be the same whichever of C's Roth IRAs made the distribution.*

***Example 7.** The facts are the same as in Example 6, except that the distribution is a qualified distribution. The result is the same as in Example 6, except that no amount would be subject to the 10-percent additional tax under section 72(t), because, to be a qualified distribution, the distribution must be made on or after the date on which the owner attains age 59 1/2, made to a beneficiary or the estate of the owner on or after the date of the owner's death, attributable to the owner's being disabled within the meaning of section 72(m)(7), or to which section 72(t)(2)(F) applies (exception for a first-time home purchase). Under section 72(t)(2), each of these conditions is also an exception to the tax under section 72(t).*

***Example 8.** Individual D makes a $2,000 regular contribution to a traditional IRA on January 1, 1999, for 1998. On April 15, 1999, when the $2,000 has increased to $2,500, D recharacterizes the contribution by transferring the $2,500 to a Roth IRA (pursuant to §1.408A-5 A-1). In this case, D's regular contribution to the Roth IRA for 1998 is $2,000. The $500 of earnings is not treated as a contribution to the Roth IRA. The results would be the same if the $2,000 had decreased to $1,500 prior to the recharacterization.*

***Example 9.** In December 1998, individual E receives a distribution from his traditional IRA of $300,000 and in January 1999 he contributes the $300,000 to a Roth IRA as a conversion contribution. In April 1999, when the $300,000 has increased to $350,000, E recharacterizes the conversion contribution by transferring the $350,000 to a traditional IRA. In this case, E's conversion contribution for 1998 is $0, because the $300,000 conversion contribution and the earnings of $50,000 are disregarded. The results would be the same if the $300,000 had decreased to $250,000 prior to the recharacterization. Further, since the conversion is disregarded, the $300,000 is not includible in gross income in 1998."* PD