THE Pension Digest

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

# Notice 98-49: Reporting for Recharacterized Contributions

The IRS has recently furnished special instructions explaining the reporting duties for recharacterized contributions.

The IRS has decided to not change the 1998 Form 1099-R or Form 5498 as previously issued. Presumably, it is too late in the year to change these forms even though some changes may be desirable. Too many forms printed. Too many software programs written.

The IRS, however, has decided to modify the previously issued instructions for completing these reporting forms. The IRS has now issued Notice 98-49.

The rules set forth in Notice 98-49 will govern for 1998 reporting purposes if the recharacterization occurs in calendar year 1998, and if there is any inconsistency between these rules and those found in the instructions for the 1998 Form 5498 or 1099-R. If the recharacterizations occurs in calendar year 1999 or later, then the custodian or trustee will report in accordance with the then current IRS instructions.

We admit to being somewhat surprised by the approach the IRS has adopted. Even though the statute uses the terminology of a trustee-to-trustee transfer to describe the situation when an IRA owner elects to treat a contribution as having been made to the second IRA and not the first IRA, the IRS adopts the approach that this movement of IRA funds or assets is reportable. That is, the involved custodians/trustees will need to generate the Form l099-R and Form 5498 to the IRS and the IRA owner. The IRS has requested comments on their approach for 1998 and their proposal for later years.

### Reporting by the Custodian or Trustee of the First IRA

The contribution to be recharacterized (be it rollover, conversion or regular/annual) will be reported on a 1998 Form 5498.

A recharacterization which occurs in 1998 will be reported as a distribution on the 1998 Form 1099-R showing Code G (for direct rollover) and showing the gross amount (contribution and earnings) in Box 1 (gross distribution) and zero (0) in Box 2a (taxable amount).

It is anticipated that a recharacterization which occurs in 1999 will be reported as a distribution on the 1999 Form 1099-R showing Code R (for a recharacterization) and showing the gross amount (contribution and earnings) in Box 1 and zero (0) in Box 2a (taxable amount).

### Reporting by the Custodian or Trustee of the Second IRA

A recharacterization contribution which is received on or before December 31, 1998, is to be reported by the custodian or trustee of the second IRA as a rollover contribution on a 1998 Form 5498.

It is anticipated that a recharacterization which occurs in 1999 (i.e. after December 31, 1998) will continue to be reported as a rollover contribution, but there will be three additional requirements. First, the check box entitled "Roth conv" on the 1998 Form 5498 will be retitled to identify a contribution as a recharacterization. Second, the custodian or trustee will check both the recharacterization box and the box that identifies the type of IRA involved. Third, the recharacterization must be reported on a 1999 Form 5498, separate from any other 1999 Form 5498 otherwise required for the second IRA. PD

# Can Roth IRAs Go Back and Forth?

There has been much written in recent weeks in newspapers and other investment periodicals about individuals who made a Roth conversion contribution wanting to undo it and then make the Roth conversion again. Or, maybe a third or fourth time! Many writers have said, "sure it can be done and there are no limits." The law may not be settled on this topic. It is certainly not as clear as it should be.

If it would be permissible, who would want to do it? Most Roth IRA accountholders convert because the value of many non-FDIC insured investments has decreased significantly.

An example. On March 3, 1998, Clare Windorski made a Roth Conversion contribution of $200,000. As of September 30, 1998, it now has a fair market value of $160,000. Must she use the 4-year spread on $200,000 (i.e. a spread of $50,000 per year) or could she use the 4-year spread on $160,000 (or $40,000 per year)? That is, should she recharacterize the original $200,000 by transferring the now $160,000

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back to the traditional IRA and then do another Roth conversion, but this time she will include only $40,000 in income for each of the four years? If Clare is in the 28% marginal tax bracket and is allowed to undo the conversion by recharacterizing it and then reconverting, then she will pay $11,200 less in taxes.

With such substantial tax savings, it is very understandable why individuals would want to do this – recharacterize and reconvert.

The problem is – the proposed regulation which the IRS issued on the subject of recharacterization either does not address the subject of how many conversion contributions may be done or it gives an unwanted answer. We think it gives the unwanted answer.

Q&A – 6(b) of the proposed regulation states that "the election and trustee-to-trustee transfer must occur on or before the due date…**and the election cannot be revoked after the transfer.**"

Does an attempt to reconvert the $140,000 in the above example constitute an attempt to revoke the recharacterized contribution? We think it does. This means the back and forth approach is not authorized by the IRS. The Roth accountholder can undo the Roth conversion (i.e. move the now $160,000 back to the traditional IRA and not have to include any amount in income because there has been no taxable distribution), but the taxpayer cannot reconvert.

We would think that if the IRA accountholder had another or different traditional IRA, that he or she could convert that one, as it is a different IRA, or if there were other nonconverted funds in the traditional IRA, those funds could be converted.

Your Roth IRA accountholders will need to act upon the advice of their own advisors. Your financial institution must do what is necessary to protect it from later claims, "but I never would have done it, but for what you told me." We recommend a written notice stating that if they do the "back and forth" transactions that they assume total responsibility for such transactions.

The IRS does have the authority to limit such recharacterizations. The statutory authority for recharacterizations is Internal Revenue Code Section 408A(6)(A) which reads, **"Except as provided by the Secretary**, if, on or before the due date for any taxable year, a taxpayer transfers…" The Secretary has provided a limit in the proposed regulation. PD

# Detailed Explanation – Recharacterized Contributions

The following discussion is based upon the IRS' recently issued proposed regulation 1.408A.

A new law permits a person to elect to treat a contribution made to a Roth IRA or traditional IRA (i.e. the first contribution) as made to the other type of IRA (i.e.the second IRA). This can be accomplished by means of a trustee-to-trustee transfer or it can be done by an internal transfer with the same trustee.

Presumably, the reason for this new law is that the lawmakers thought it was desirable to create a method to correct an excess or unwanted contribution which does not require an actual distribution. The lawmakers definitely wanted to give those people who did not satisfy the $100,000 limit a way to undo the conversion. However, there are many reasons a person who initially makes a contribution to a Roth IRA and then decides he or she should not have done so, or vice versa.

The concept is: the contribution as made to the first IRA which is being recharacterized is treated on the individual's federal income tax return as having been originally contributed to the second IRA on the same date and (in the case of regular contribution) for the same taxable year that the contribution was made to the First IRA. The income is considered earned by the second IRA. A recharacterized contribution is not treated as a rollover for purposes of the one-rollover-per-year limitation.

This election can be made only if accomplished on or before the due date (including extensions) for filing the person's Federal income tax return for the taxable year for which the contribution was made to the First IRA. For this purpose, an actual distribution from a traditional IRA late in a calendar year which is then rolled over to a Roth IRA (conversion method #l) in the following calendar year is treated as being contributed in the earlier calendar year. This means that the election must be made by April 15 (plus extensions) of the first succeeding year and not the second succeeding year.

An election to recharacterize a contribution cannot be revoked after the transfer.

In order to have a qualifying recharacterization, the net income attributable to the contribution being recharacterized must be transferred to the Second IRA. The method used to calculate the net income is the method used to calculate the earnings associated with an excess contribution to a traditional IRA.

A person cannot (i.e. is not eligible to) recharacterize employer contributions to a SIMPLE-IRA or a SEP-IRA as contributions to another type of IRA.

A person cannot recharacterize a contribution to the First IRA if it was a tax-free contribution (i.e. a rollover or a transfer). However, if a person has made a nonqualifying rollover or transfer, then it is treated as a regular contribution (albeit an excess contribution) which means it does qualify for recharacterization.

The fact that a rollover or transfer (i.e. a tax-free transfer) has occurred from the First IRA to a subsequent IRA does not mean that the IRA contributor cannot recharacterize the initial contribution as long as the other rules are met. The subsequent IRA is deemed to be the first IRA for these purposes. The rollover or transfer is ignored and the characterization is permissible.

In order to make an election to recharacterize a contribution, the IRA contributor/taxpayer must do the following. He or she must notify both the custodian/trustee of the First IRA and the Second IRA that he or she has elected to treat the contribution as having been made to the Second IRA, instead of the First IRA for Federal income tax purposes. This notification must be furnished on the date of the transfer (i.e. simultaneously) or before the date of the transfer. The notification must also include the following information:

1. Type and amount of the contribution to the First IRA that is to be recharacterized;

2. The date on which the initial contribution was made;

3. A direction to the custodian or trustee of the First IRA to transfer it in a custodian/trustee-to-custodian/trustee transfer the amount of the contribution plus the allocable net income to the custodian/trustee of the Second IRA;

4. The name of the first trustee and the second trustee; and

5. Any additional information needed to make the transfer.

The IRS has furnished the following examples to illustrate these rules.

*Example 1.* In 1998, Individual C converts the entire amount in his traditional IRA to a Roth IRA. Individual C thereafter determines that his modified AGI for 1998 exceeded $100,000 so that he was ineligible to have made a conversion in that year. Accordingly, prior to the due date (plus extensions) for filing the individual's Federal income tax return for 1998, he decides to recharacterize the conversion contribution. He instructs the trustee of the Roth IRA (FIRST IRA) to transfer in a trustee-to-trustee transfer the amount of the contribution, plus net income, to the trustee of a new traditional IRA (SECOND IRA). The individual notifies the trustee of the FIRST IRA and the trustee of the SECOND IRA that he is recharacterizing his IRA contribution (and provides the other information described in A-6 of the regulation). On the individual's Federal income tax return for 1998, he treats the original amount of the conversion as having been contributed to the SECOND IRA and not the Roth IRA. As a result, for Federal tax purposes, the contribution is treated as having been made to the SECOND IRA and not the Roth IRA. The result would be the same if the conversion amount had been transferred in a tax-free transfer to another Roth IRA prior to the recharacterization.

*Example 2.* In 1998, an individual makes a $2,000 regular contribution for 1998 to his traditional IRA (FIRST IRA). Prior to the due date (plus extensions) for filing the individual's Federal income tax return for 1998, he decides that he would prefer to contribute to a Roth IRA instead. The individual instructs the trustee of the FIRST IRA to transfer in a trustee-to-trustee transfer the amount of the contribution, plus attributable net income, to the trustee of a Roth IRA (SECOND IRA). The individual notifies the trustee of the FIRST IRA and the trustee of the SECOND IRA that he is recharacterizing his $2,000 contribution for 1998 (and provides the other information described in A-6 of the regulation). On the individual's Federal income tax return for 1998, he treats the $2,000 as having been contributed to the Roth IRA for 1998 and not to the traditional IRA. As a result, for Federal tax purposes, the contribution is treated as having been made to the Roth IRA for 1998 and not to the traditional IRA. The result would be the same if the conversion amount had been transferred in a tax-free transfer to another traditional IRA prior to the recharacterization.

*Example 3.* The facts are the same as in *Example 2,* except that the $2,000 regular contribution is initially made to a Roth IRA and the recharacterizing transfer is made to a traditional IRA. On the individual's Federal income tax return for 1998, he treats the $2,000 as having been contributed to the traditional IRA for 1998 and not the Roth IRA. As a result, for Federal tax purposes, the contribution is treated as having been made to the traditional IRA for 1998 and not the Roth IRA. The result would be the same if the contribution had been transferred in a tax-free transfer to another Roth IRA prior to the recharacterization, except that the only Roth IRA trustee the individual must notify is the one actually making the recharacterization transfer.

*Example 4.* In 1998, an individual receives a distribution from traditional IRA 1 and contributes the entire amount to traditional IRA 2 in a rollover contribution described in section 408(d)(3). In this case, the individual cannot elect to recharacterize the contribution by transferring the contribution amount, plus net income, to a Roth IRA, because an amount contributed to an IRA in a tax-free transfer cannot be recharacterized. However, the individual may convert (other than by recharacterization) the amount in traditional IRA 2 to a Roth IRA at any time, provided the requirements of § 1.408A-4 A-1 are satisfied.

## Reporting a Distribution from a "Combo" Roth IRA

Prior to the technical corrections, the IRS was strongly recommending that Roth IRA conversion contributions not be combined with any annual Roth IRA contributions. The IRS has not yet publicly stated if it is still making this recommendation. The primary reason was that the five-year holding requirement applied separately to Roth IRA conversion contributions from annual Roth IRA contributions.

Regardless of whether the IRS changes its position on this issue, it was possible under the "old" law and is now possible under the "new" law to combine an annual Roth IRA contribution with a Roth IRA conversion contribution within the same Roth IRA. The IRS in Notice 98-49 has addressed the following administrative question: What reason code in box 7 of the Form 1099-R is to be used if there is a distribution from such a Roth IRA? The IRS has said in Notice 98-49 that Code K (Distribution from a 1998 Roth Conversion IRA in the first 5 years) must be used. Presumably, the IRS adopts this position because the IRA custodian or trustee does not really know what portion of the distribution is attributable to annual contributions versus conversion contributions because of the aggregation rules.

## Required Distributions from a Roth IRA

It may be somewhat surprising, but there are required distribution rules which apply to Roth IRAs. There are no distributions mandated while the Roth IRA accountholder is alive, but distributions are mandated after the Roth accountholder dies. What makes this subject confusing, is that the rules which apply after a Roth IRA accountholder dies are to be similar to those rules which apply to a traditional IRA accountholder if he or she dies before his or her required beginning date. Generally, these are the five-year rule and the life-distribution rule.

In late 1997, the IRS wrote its model Roth forms to contain the following rules.

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 Roth IRA of the surviving spouse. No election is required.

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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 year of the accountholder's death. 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) and this factor will be reduced by one for each succeeding year. The balance to be used in the calculation is — the entire interest in the inherited account as of the close of business on December 31 of the preceding year.

Note that the age to be used for a spouse beneficiary is the beneficiary's age in the year the accountholder dies, and is not the year he or she would have reached age 70 1/2. The spouse beneficiary is not permitted to elect to use the recalculation method. The age of each beneficiary is determined and used; not just the age of the oldest beneficiary as is done with the traditional IRA.

The IRS has now presented a different approach (i.e. different rules) in its proposed regulation and Notice 98-49. It may be possible that the IRS will revise its Model forms for this reason and for some other reasons.

In newly released Notice 98-49, the IRS stated that the model forms can be amended to give a surviving spouse who is the sole designated beneficiary the option of not treating the Roth IRA as his or her own.

In the proposed regulation, the IRS states the rules as they probably should have been stated in the model Roth IRA forms. The following statement is made:

*"The minimum distribution rules apply to the Roth IRA as though the Roth IRA owner died before his or her required beginning date. Thus, generally, the entire interest in the Roth IRA must be distributed by the end of the fifth calendar year after the year of the owner's death unless the interest is payable to a designated beneficiary over a period not greater than that beneficiary's life expectancy and distribution commences before the end of the calendar year following the year of death. If the sole beneficiary is the decedent's spouse, such spouse may delay distributions until the decedent would have attained age 70½ or may treat the Roth IRA as his or her own."* PD

# ✓✓✓ Check It Out ✓✓✓

**Question: Will distributions from a Roth IRA ever have the result that the taxpayer will have all or some portion of his or her social security benefits become subject to income tax? If one must include nontaxable interest in the calculation, shouldn't one be required to include the nontaxable distributions from a Roth IRA in the calculation?**

✓ Answer. As the law is written, those distributions from a Roth IRA which are entitled to be excluded from income will NOT have the effect of increasing the amount of income tax a person will pay with respect to his or her social security benefits.

Warning. As you know, tax laws may be rewritten at the will of Congress and the President. Thus, what is not taxable today may be taxable tomorrow.

Note that distributions from a Roth IRA which are not entitled to be excluded from income (i.e. must be included in income) may have the effect of increasing the amount of income tax a person will pay with respect to his or her social security benefits as does the amount converted from a traditional IRA to a Roth IRA.

**Situation/Question: You have a customer who wishes to move funds from her Tax-Sheltered Annuity (TSA) (section 403(b)) into an IRA via a rollover or a direct rollover. Your customer is well over age 70 1/2. You asked about her RMD calculations - the calculation which applied to the TSA and the calculation to be used for the IRA. Do RMD rules apply to section 403(b) plans?**

✓ Answer. Yes. Special RMD rules do apply for TSAs. The RMD rules were first applied to TSAs as of 1-1-87. Therefore, the law grandfathered in the "balances" as of 12-31-86. The old law continues to govern the 12-31-86 balance and the current RMD rules govern amounts contributed or accumulated after 12-31-86. In general, the RMD rules which apply to TSA balances accumulated after 12-31-86 are the same rules which apply to IRAs.

The general rule of law is that when funds move from one type of retirement account into another type, the special rules which applied to the transmitting account no longer apply. For example, when funds are moved from a qualified plan to an IRA, a future distribution from the IRA will not qualify for 5- or 10-year averaging. Thus, the special TSA rules which might have applied to the grandfathered portion will no longer apply. I use the term "might" because proper records need to exist in order to be able to gain the benefit of the grandfathered rule. If proper records were not maintained for her TSA, then she was required to comply with the standard RMD rules.

Once the funds are IRA funds, the IRA RMD rules will apply to the entire balance. The factors needed to make the IRA calculation are: (1) recalculation versus nonrecalculation and (2) the date of birth of the designated beneficiary in order to determine the joint or single factor. Whatever factors applied for the post-1986 account balance under the TSA should also apply to the IRA. The TSA should include a default provision - if the person did not expressly elect recalculation or not, then the TSA will state which is deemed to have been elected. Normally, this is recalculation, but not always. Someone needs to look at the TSA.

If this information cannot be found, I would suggest that you have her confirm who her beneficiary under the annuity was as of her required beginning date. Then she should instruct you to use the recalculation or the nonrecalculation method and state that she assumes responsibility if any problems would arise because proper records had not been maintained. PD

*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.*