THE Pension Digest

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IRA Imposes Limits on Number of Roth Reconversions

The IRS recently issued Notice 98-50. This Notice addresses the topic of whether or not a person is eligible to reconvert any amount from a traditional IRA to a Roth IRA. This Notice creates interim rules (i.e. limits) which govern for 1998 and 1999. This Notice is to be considered the same as an amendment to the proposed regulation where the recharacterization rules were explained. The IRS will adopt final rules on governing reconversions in the final Roth IRA regulations. The IRS puts people on notice that the IRS could decide to not permit reconversions under any circumstances or could adopt more restrictive limits than those adopted within the Notice. A reconversion is defined to be all movements of an amount from a traditional IRA to a Roth IRA except for the first movement of such amount which is defined to be a conversion. Simply put, reconversions are all conversions occurring after the first one.

Why the need or desire for limits?

As discussed in the August newsletter, if a taxpayer has an unlimited right to recharacterize a previous conversion contribution and then reconvert, it would mean the IRS would bear the risk of decreases in the market value of investments. The IRS (rightly so) does not feel the U.S. government should bear all of this risk. Example. Paula Jones converts $80,000 on 5-10-98, and invests this amount in mutual funds owned by her Roth IRA. After the conversion, she believes she will include $20,000 in income for the years 1998-2001. The stock market sours in August and September. On October 15, 1998, the value of her mutual funds is $60,000. She elects to recharacterize the conversion so that the funds go back to a traditional IRA. She now elects to reconvert. Rather than including $20,000 in income over four years, now she will include only $15,000 in income over four years and will pay fewer income taxes. And, if the $60,000 would increase again to $80,000, then she will never pay income taxes on the $20,000 and any other earnings within the Roth as long as there is a qualified distribution from the Roth IRA. So, the issue to the IRS is the failure to collect income taxes.

What are the limits on reconversions for 1998 and 1999?

First, if a person converts an amount from a traditional IRA to a Roth IRA in 1998 and then transfers that amount back to a traditional IRA by means of a recharacterization, then a person is eligible to reconvert that amount to a Roth IRA once (but no more than once) during the period of November 1, 1998, to December 31, 1998, and the person is also eligible to reconvert that amount once during the period of January 1, 1999, to December 31, 1999. Second, if the person converts an amount once during the period of January 1, 1999, to December 31, 1999, and then transfers it back to a traditional IRA by means of a recharacterization, then the person is eligible to reconvert that amount to a Roth IRA once (but no more than once) during the same period. Third, if the person does not comply with the above two rules, then his or her attempted reconversion is defined to be an "excess reconversion." However, any reconversion which occurred before November 1, 1998, is deemed to comply with the rules (i.e. is grandfathered and is not an excess reconversion) and does not counts towards the limit of one.

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The Five-Year Requirement for SEPPs

More and more IRA accountholders who are not yet age 59 1/2 are electing to establish substantially equal periodic payments (SEPPs). Establishing a substantially equal periodic payment schedule is an exception to the 10% additional tax of Code section 72(t). The tax law provides a special 10% recapture tax if the accountholder would modify his or her schedule by taking an additional distribution prior to the later of—attaining age 59 1/2 or the schedule being in effect for five years. This 10% tax is equal to the total of all the previous distributions which otherwise escaped the general 10% additional tax multiplied by 10%.

A recent tax court case dealt with the issue of whether or not the taxpayer had complied with the five-year requirement. The taxpayer took his first year's payment in December of 1989 when he was age 55. He then took payments for years two to five in January of 1990, 1991, 1992 and 1993. He was paid an additional distribution in November of 1993, after he had attained age 59 1/2.

Had he complied with the five-year requirement? He argued that since he had

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Roth Reconversion—*Continued from page 1*

What is the consequence of having an excess reconversion?

An excess reconversion occurring in 1998 or 1999 is treated as a valid reconversion except it (and the preceding recharacterization) are ignored for purposes of determining the taxpayer's taxable conversion amount. Example. Kristie Phillips converts $90,000 on July 5, 1998. She recharacterizes this amount on September 4, 1998, when it has value of $70,000. She reconverts it on November 11, 1998, when it has a value of $75,000. She recharacterizes this on November 30, 1998, when it has a value of $70,000. On December 10, 1998, she reconverts it when it has a value of $65,000. For income tax purposes, the taxable conversion amount is $75,000 and not $90,000 (the first conversion) or $65,000 (the third conversion which was an excess reconversion).

Is the limit of one per taxpayer, per traditional IRA plan agreement, or per amount?

The IRS does not address this issue as clearly as is desired. It certainly appears that the limit is a "per amount" limit. Thus, if there was $90,000 in an IRA and the person converted only $40,000, recharacterized it and then reconverted it, then this person would still be eligible to convert (not reconvert) the other $50,000. The IRS should give additional guidance on this issue.

The IRS also sets forth the following examples to illustrate the rules of Notice 98-50.

Example 1. On May 1, 1998, T converted an amount in a traditional IRA (Traditional IRA 1) to a Roth IRA (Roth IRA 1). T did not contribute any other amount to Roth IRA 1. On October 15, 1998, T transferred the amount in Roth IRA 1 to a traditional IRA (Traditional IRA 2) by means of a recharacterization. T is eligible to reconvert the amount in Traditional IRA 2 to a Roth IRA once (but no more than once) at any time on or after November 1, 1998, and on or before December 31, 1998. Any additional reconversion during 1998 would be an excess reconversion. This result would not be different if the recharacterization had occurred on or after November 1, 1998, instead of before November 1, 1998.

Example 2. The facts are the same as in *Example 1*, except that, on November 25, 1998, T reconverts the amount in Traditional IRA 2 to a Roth IRA (Roth IRA 2). After that reconversion, T may transfer the amount from Roth IRA 2 back to a traditional IRA by means of a recharacterization, but any subsequent reconversion of that amount to a Roth IRA before January 1, 1999, would be an excess reconversion. If T does transfer the amount from Roth IRA 2 back to a traditional IRA by means of a recharacterization, T is eligible to reconvert that amount once (but no more than once) during 1999. Any additional reconversion of that amount during 1999 would be an excess reconversion.

Example 3. The facts are the same as in *Example 2*, except at on December 4, 1998, T transfers the amount from Roth IRA 2 back to a traditional IRA (Traditional IRA 3) by means of a recharacterization. If T does not reconvert that amount to a Roth IRA on or before December 31, 1998, T cannot use the 4-year spread available for 1998 conversions.

Example 4. The facts are the same as in *Example 3.* The value of the amount converted on May 1, 1998, was $X, and the value of the amount converted on November 25, 1998, was $Y. On December 8, 1998, T reconverts the amount in Traditional IRA 3 (which then has a value of $Z) to a Roth IRA (Roth IRA 3). Under the interim rules set forth in this notice, T is not eligible to make the December 8, 1998, reconversion, and that excess reconversion will not be taken into account for purposes of determining T's taxable conversion amount (although it is otherwise treated as a valid conversion). Instead, T's taxable conversion amount will be based on T's November 25, 1998, reconversion. Therefore, T's taxable conversion amount will be $Y. Because it is a 1998 conversion, the November 25, 1998, reconversion is eligible for the 4-year spread (unless T again transfers the amount from Roth IRA 3 to a traditional IRA by means of a recharacterization).

Example 5. The facts are the same as in *Example 2*, except that T's modified AGI for 1998 was $100,000. Therefore, T was not eligible to convert an amount from a traditional IRA to a Roth IRA in 1998, and T's attempted conversion (on May 1, 1998) and reconversion (on November 25, 1998) are failed conversions, as described in proposed regulations § 1.408A–4, Q&A–3. Therefore, if T transfers the amount of the failed conversion in Roth IRA 2 back to a traditional IRA by means of a recharacterization and converts that amount from the traditional IRA to a Roth IRA during 1999, T will be eligible to reconvert that amount once (but no more than once) on or before December 31, 1999. Any additional reconversion of that amount during 1999 would be an excess reconversion.

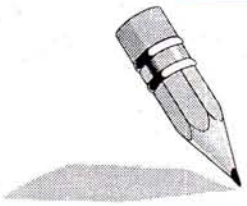
Example 6. On November 5, 1998, R converts an amount in a traditional IRA (Traditional IRA 1) to a Roth IRA (Roth IRA 1). On November 25, 1998, R transfers the amount in Roth IRA 1 back to a traditional IRA (Traditional IRA 2) by means of a recharacterization. R is then eligible to reconvert the amount in Traditional IRA 2 to a Roth IRA at any time on or before December 31, 1998. After that reconversion, R may transfer the amount back to a traditional IRA by means of a recharacterization, but any subsequent reconversion of that amount to a Roth IRA before January 1, 1999, would be an excess reconversion. If R does transfer the amount back to a traditional IRA by means of a recharacterization (whether before or after the end of 1998), R will be eligible to reconvert that amount once (but no more than once) during 1999. Any additional reconversion of that amount during 1999 would be an excess reconversion.

Example 7. On January 5, 1999, S converts an amount in a traditional IRA (Traditional IRA 1) to a Roth IRA (Roth IRA 1). S had not previously converted that amount. On February 17, 1999, S transfers the amount in Roth IRA 1 back to a traditional IRA (Traditional IRA 2) by means of a recharacterization. After the recharacterization, S is eligible to reconvert the amount in Traditional IRA 2 once (but no more than once) at any time on or before December 31, 1999. Any additional reconversion of that amount during 1999 would be an excess reconversion. PD

5-Year Requirement—*Continued from page 1*

already received five distributions by the time of the November distribution, the five-year requirement had been met. The IRS argued that he had not met this requirement since the five-year requirement is determined from the date of the first distribution and not the year for which the distribution was taken. Therefore, the 10% recapture tax applied to the five scheduled distributions. The 10% tax did not apply to the November distribution since the taxpayer was older than age 50 1/2 for that distribution. The United States Tax Court adopted the position put forth by the IRS.

The court case was Robert C. and Nancy Arnold v. Commissioner of Internal Revenue, United States Tax Court, Docket #97-2150, 9-28-98. PD



Completing the 1998 Form 945, Annual Return of Withheld Federal Income Tax on Forms 1099 and W-2G

Form 945 is the reporting form which a financial institution (or other filers) must file to summarize the amount it has withheld from nonpayroll payments: backup withholding, IRA/pension withholding, gambling winnings, military retirement, Indian gaming profits and voluntary withholding on certain government payments.

Most financial institutions need to file Form 945 because they have had backup withholding and IRA/pension withholding. If your institution did not withhold during 1998 (i.e. it did not have a nonpayroll tax liability), then there is no duty to file the Form 945 for 1998. If your institution did withhold, then it is required to file the Form 945. The deadline is February 1, 1999. However, if you made deposits on time in full payment of the taxes for the year, you may file the return by February 10. The EIN which is inserted on the Form 945 must match the EIN number used on the applicable 1099 form or the deposit form (Electronic Federal Tax payment System 8109). The mandatory deposit schedule for nonpayroll taxes is different than it is for payroll taxes. There are only two deposit schedules—monthly or semiweekly. Whether or not you are required to deposit via EFTPS depends upon all deposit tax liabilities and not just nonpayroll tax liabilities.

Specific Instructions

State Code (up in address label area). There are two small boxes. Do not make an entry if you made all of your deposits with a federal reserve bank or an authorized financial institution located in the same state as your address. Enter "MU" if you made deposits in more than one state. If you made your deposits in a state other than the one listed on your address, then enter the two-letter postal service abbreviation for that state.

Line 1—Federal Income Tax Withheld. You enter the income tax you withheld from IRAs, pension, annuities, military retirement, Indian gaming profits, voluntary withholding on certain government payments and gambling winnings. If your institution has only withholdings from IRAs and pensions, then line 1 should equal the aggregate total of all amounts in box 4 of the 1099-R forms.

Line 2—Backup Withholding. You enter the aggregate total of all backup withholding.

Line 3—Adjustment to Correct Administrative Errors. As with most provisions in the tax law, the term administrative error has a specific meaning. An administrative error occurs if the amount you entered on Line 1 or line 2 does not match the amount you actually withheld. Once you discover such an error, you must report it on the Form 945 for the year in which you discover the error. You must report the adjustment on line 3 and also complete Form 941c, Supporting Statement to Correct Information. You must file the Form 941c with the Form 945.

Line 4—Total Taxes. Sum of lines 1 and 2 as modified by line 3.

Line 5—Total Deposits. Self-explanatory.

Line 6—Balance Due. You should have a balance due only if your taxes on line 4 are less than $500. Any payment still due should be paid by Form 8109 or EFTPS and not paid with the Form 945.

Line 7—Overpayments.

Line 8—Monthly Summary of Federal Tax Liability. This is a summary of your monthly tax liability and not of your deposits. However, you must use Form 945-A rather than line 8 if you are a semiweekly depositor. PD

Minimal Activity—MSAs

The IRS has ruled in IRA Announcement 98-88 that there have been too few MSAs established, so October 1, 1998, is not a "cut-off" date, and 1998 is not a cut-off year. The number of MSA returns filed for 1997 which count against the statutory limit was 26,160. The number of MSAs established in 1998 which count against the statutory limit is 10,651.

The Health Insurance Portability and Accountability Act of 1996 created a pilot program for Medical Savings Accounts. The law provides that the year 2000 is a cut-off year unless certain numerical limits are exceeded in earlier years in which case the earlier year is the cut-off year. The general rule is—no individual will be eligible for a deduction or exclusion of MSA contributions for any tax year beginning after the cut-off year unless the individual was an active participant for any tax year ending on or before the close of the cut-off year or because he or she becomes an active MSA participant for a tax year after the cut-off year by reason of coverage under a high-deductible health plan of an MSA participating employer.

Conclusion: Right now it looks like MSAs will not be cut off until 12-31-2000. PD

PTE 93-33 & 97-11—To Be Amended

The Department of Labor has proposed to amend two previously issued prohibited transaction class exemptions to include Education IRAs and SIMPLE-IRAs. PTE 93-33 (banks) and PTE (brokerage firms) allows these entities to provide free or low-cost services as incentives for maintaining IRAs even though they normally would be prohibited transactions. The DOL proposes to amend these PTEs so that Education IRAs and SIMPLE-IRAs would be given the same treatment. The DOL has determined that no such amendment is needed for Roth IRAs because the statute which creates the Roth IRA (section 408A) incorporates all of Code section 408(a). At the present time the DOL is not willing to also include medical savings account.

If adopted, the proposed exemptions would be effective January 1, 1998. There will be a public hearing in December. Most likely such services have already been rendered. But since the amendment will be retroactive to January 1, 1998, any past problems will most likely be corrected. PD

✔✔✔ Check It Out ✔✔✔

Situation/Question #1: Six months ago our bank bought another bank which had 3,800 IRAs. This bank had bought a third bank over two years ago. Of those 3,800 IRAs, 900 arose from that purchase. Francene Sabin has established an IRA with that third bank. She had $48,000 in her IRA. She died on 11-5-98. Her daughter came into the bank to check on the account. We went to her file, and we could not locate a plan agreement form or a beneficiary designation form. What should we do with respect to Ms. Sabin's account? What about the other files with the same situation?

✔ Answer: Your bank must first resolve the problem with respect to the Sabin file. Most likely the bank's attorney should be involved even at this stage. The bank does not want to pay the wrong party. You do not want to pay out $48,000 two times. The bank will need to do a detailed search of its files to see if the missing plan agreement and beneficiary designation can be found. You may want to contact former employees, if necessary, to try to find these missing files or to obtain an explanation as to how the IRAs were maintained. If the missing information cannot be found, then an explanation may need to be given to the family to see if the family can provide the missing documents from the decedent's files. If the missing information still cannot be found, then we believe the bank must try to obtain "releases" from all possible claimants so that the funds may be distributed to the decedent's estate. Most IRA plan agreements provide that the funds will be paid to the decedent's estate if a beneficiary has not been designated. Someone needs to try to determine what was the most recent plan agreement which "controlled" this IRA. If the necessary releases cannot be obtained, then the bank will need to go to court, interplead all possible claimants and then have the court make a decision. This is going to be an expensive process. Your bank does not want to do this very often, if ever. Judges are not going to be impressed that files have been poorly maintained.

Almost immediately after starting to resolve the Sabin situation, the bank must begin to solve the larger problem. The bank must start a conversion project so that IRA plan agreements and beneficiary designations are obtained for all files. The signature of the IRA accountholders must be obtained.

Situation/Question #2. Bud Webster is self-employed. He owns a small business which has 12 employees, including himself. He established a SIMPLE plan for his business in 1997. All employees, including himself, signed elective deferral instructions forms early in 1998. Although contributions have been made per paycheck for his employees, he has not made any actual deferral contributions into his own SIMPLE-IRA because he has decided to wait until he knows his "final compensation" after his tax return is completed. In completing the Form 5305-SIMPLE, he allowed all participants the flexibility of changing their deferral instruction. It is now November; what should he do?

✔ Answer: He or his accountant needs to do a preliminary preparation of his income tax return in late November or early December so he can determine his net income. Waiting until January or February may well be too late. He then needs to decide on the percentage/amount which he wishes to defer. Remember that a self-employed person with only $12,000 of business net earnings could still defer $6,000 plus receive his 3% matching contribution. The point: he must "set" in December (i.e. on or before 12-31-98) his deferral percentage/amount. He cannot set or change this deferral percentage/amount for 1998 in 1999. He must complete the Form 5305-SIMPLE so that he has the right to change his deferral percentage/amount in December of each year.

Situation/Question #3: Sergei B. is an active participant in the 401(k) plan which his employer sponsors. He is 48 years old. Sergei's modified adjusted gross income (MAGI) will be $35,000 for 1998. Sergei is not married. What type of IRA contributions is he eligible to make?

✔ Answer: He may contribute $2,000 to a Roth IRA. Being an active participant does not impact the permissibility of making a Roth IRA contribution. Or, he may also contribute $2,000 to a traditional IRA, but only $1,000 of such contribution would be deductible since he is an active participant and his MAGI is $35,000. Or, he could choose to contribute to both type of IRAs, but the overall combined contribution limit is $2,000.

Situation/Question #4: Same as #3 except Sergei's MAGI is $70,000. What type of IRA contributions is he eligible to make?

✔ Answer: He may contribute $2,000 to a Roth IRA. Being an active participant does not impact the permissibility of making a Roth IRA contribution. Or, he may also contribute $2,000 to a traditional IRA, but he would not be entitled to deduct any portion of this contribution because he is an active participant and his MAGI is $70,000. Or, he could choose to contribute to both type of IRAs, but the overall combined contribution limit is $2,000.

Situation/Question #5: Same as #3 except Sergei's MAGI is $120,000. What type of IRA contributions is he eligible to make?

✔ Answer: He is not eligible to make a Roth IRA contribution because his MAGI exceeds the $110,000 limit. He is eligible to contribute $2,000 to a traditional IRA, but he would not be entitled to deduct any portion of this contribution because he is an active participant and his MAGI is $120,000. 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.