THE Pension Digest

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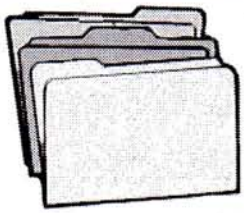

What Value—Maintaining Separate Roth IRAs!

What reasons, if any, are there to keep Roth conversion contributions separate in one Roth IRA and annual Roth contributions in a second Roth IRA? Does the fact that the accountholder has or has not attained the age of 59 1/2 affect the answer in any way?

Historical Background

The original Roth law provided that each conversion contribution was subject to a five-year holding requirement to determine if a distribution was qualified or non-qualified for income taxation purposes. This five-year period could be different than that which applied to annual contributions or other conversion contributions made during a different calendar year. Thus, the IRS wrote its model Roth IRA forms and strongly suggested that a separate Roth IRA (i.e. a Conversion Roth IRA) be established for Roth conversion contributions so that it would be easier to determine if the five-year requirement had been met or not met, so that one could determine the portion of any distribution which would be required to be included in income and subject to being taxed. It should be noted that even under the existing model Roth IRA agreements, it was and is possible to combine conversion and annual contributions.

The technical corrections bill enacted in July of 1998 changed the law so that for inclusion in income purposes, the taxpayer needs to calculate only one five-year period for both annual and conversion contributions. This technical corrections bill, however, created a new 10% recapture tax to be assessed against certain people who avoided the 10% additional tax when they converted their traditional IRA to a Roth IRA. This 10% additional tax applied to each separate conversion amount. The 10% additional tax is to be assessed if there is a subsequent distribution of converted funds before a five-year holding requirement has been met. However, this 10% additional tax is not assessed if, at the time of the subsequent distribution, one of the exceptions of section 72(t) applies. Thus, if an accountholder subsequently attains age 59 1/2 and then takes a distribution (but before the five-year requirement is met), the 10% additional tax is not assessed or owed.

Does the existence of this new 10% recapture tax mean the Roth accountholder should establish and maintain separate Roth IRAs?

At first we at CWF thought it did, but for the reasons discussed in this article, we no longer do. In most situations, we see no reason why a person should maintain separate Roth IRAs—one for a conversion and one for annual contributions—because the law mandates the aggregation of separate IRAs to determine the tax consequences of any distribution. Since the law mandates the aggregation of all Roth IRAs, a person is no worse off if he or she combines within one Roth IRA both conversion and annual contributions.

A general discussion of these subjects follows along with some illustrations.

For inclusion in income purposes, all Roth IRAs are aggregated and then there are ordering rules to determine if the amount distributed is required to be included in income to any extent. The law mandates that distributions are deemed made from the following sources and in the following order: (1) annual contributions; (2) conversion contributions on a first-in-first-out basis, and (3) earnings.

For purposes of assessing the 10% addi-

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Paying the Wrong Beneficiary?

It may not be a happy thought, but at times an IRA custodian/trustee may need to seek to recover an improper payment.

The Minnesota Court of Appeals in the case of Great Western Bank v. Wymon Henderson, No. C6-97-2151, recently ruled that the IRA trustee was entitled to recover the erroneous payment on theories of unjust enrichment, mistake and restitution.

The situation. An IRA accountholder had designated his son as his primary beneficiary. A few weeks before his death, he had changed his primary beneficiary to his sister. The IRA trustee was slow to process the change in beneficiary. It paid the son.

The IRA trustee had to work harder than it probably wanted to recover these funds. The court commenced a law suit in a state court in Minnesota. This state court case was stayed as the IRA trustee commenced an interpleader action in Florida federal court. However, the federal court ruled that the interpleader action was not available because the IRA trustee no longer had an interest in the IRA funds because they had been distributed. The state court then ruled against the trustee because it adopted the position of the federal court. The Minnesota Appellate Court

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tional tax in a recapture situation (i.e. a withdrawal by a person after a conversion which occurs within five years after the conversion), there is a separate five-year requirement for each conversion contribution. The five-year period for the purpose of this additional 10% tax need not be the same period as the five-year period used to determine if the distribution is a qualified distribution for purposes of determining if the income will not be taxed.

Hypothetical Situation. Pat Dressel is age 53 in 1998. Her date of birth is 3-13-45. As of 12-31-97, she maintained three different traditional IRAs as follows:

IRA #1	$60,000	at Institution ABC
IRA #2	$12,000	at Institution DEF
IRA #3	$18,000	at Institution GHI

On 1-3-98, she converted the $60,000 of IRA #1 into Roth IRA #1. She elected to include the $60,000 in gross income for 1998. This Roth IRA #1 has the following fair market values. These values have not been adjusted for any hypothetical distributions.

12-31-98	$65,000
12-31-99	$70,000
12-31-00	$80,000
12-31-01	$75,000
12-31-02	$82,000
12-31-03	$88,000
12-31-04	$100,000
12-31-05	$94,000
12-31-06	$110,000
12-31-07	$115,000
12-31-08	$100,000
12-31-09	$107,000

On 1-2-98, she contributed $2,000 to Roth IRA #2. And she makes annual contributions of $2,000 on each subsequent January 2 for the next 10 years, to Roth IRA #2. It accumulates as follows:

12-31-98	$2,140
12-31-99	$2,430
12-31-00	$6,880
12-31-01	$9,501
12-31-02	$12,307
12-31-03	$15,308
12-31-04	$16,594
12-31-05	$19,895
12-31-06	$23,428
12-31-07	$27,208
12-31-08	$31,252

On 1-3-01, she converts IRA #2 into Roth IRA #3 when it has a value of $20,000. It accumulates as follows:

12-31-01	$22,000
12-31-02	$24,000
12-31-03	$36,000
12-31-04	$28,000
12-31-05	$33,000
12-31-06	$36,000
12-31-07	$42,000

On 1-3-04, she converts IRA #3 into Roth IRA #4 when it has a value of $36,000. It accumulates as follows:

12-31-04	$40,000
12-31-05	$41,000
12-31-06	$42,000
12-31-07	$45,000

What are the tax results if the following distributions take place? Each distribution scenario assumes the prior distributions did not take place.

1. $5,000 is withdrawn from Roth IRA #1 on 2-10-01.

Discussion. She has made $8,000 of annual contributions. These contributions actually went into Roth IRA #2. She has withdrawn $5,000 from Roth IRA #1. At the time of distribution she is age 55. For application of the income taxation rules, all Roth IRAs must be aggregated. Because annual contributions are deemed distributed first, no portion of the $5,000 withdrawal is included in income. And the 10% additional tax will not apply even though there has been a withdrawal from Roth IRA #1 before the five-year period has expired because the distribution is deemed to have come from Roth IRA #2. She will now have an "annual contribution basis" of $3,000 rather than $8,000.

2. Same situation as #1 except the $5,000 is withdrawn from Roth IRA #2.

Discussion. Same analysis as was given for #1 applies. Because of the ordering rules, it makes no difference, for determination of income tax consequences, from which Roth IRA the actual distribution takes place.

3. $9,000 is withdrawn from Roth IRA #2 on 4-5-01.

Discussion. She withdraws $9,000 when her annual contribution basis is only $8,000. This means she is deemed to have withdrawn $1,000 from her first conversion contribution. This $1,000 is not subject to being included in income, but it is subject to the 10% additional tax (10% x $1,000) or $100. At the time of distribution, she is age 56. Note that she has actually withdrawn "earnings" from this Roth IRA #2, but under the ordering rules, earnings are deemed distributed last.

4. $80,000 is withdrawn from Roth IRA #1 on 4-5-03.

Discussion. Her annual contribution basis is $12,000, and this is deemed to be distributed first. Then conversion amounts are deemed distributed in order of when converted. Thus, the first conversion amount of $60,000 is deemed distributed. Because the five-year period for this conversion has expired, the 10% additional tax does not apply. The remaining $8,000 is deemed to have come from the second conversion which occurred on 1-3-01. The 10% additional tax does apply to this $8,000, so $800 will be owing. At the time of distribution she is not yet age 59 1/2; she is 58 plus. Note that she has actually withdrawn "earnings" from this Roth IRA #2 of $20,000, but under the ordering rules, earnings are deemed distributed last.

5. $ 14,000 is withdrawn from Roth IRA #3 on 8-5-03.

Discussion. Her annual contribution basis is $12,000, and this is deemed to be distributed first. Then conversion amounts are deemed distributed in order of when converted. Thus, $ 2,000 of the first conversion amount of $60,000 is deemed distributed. Because the five-year period for this conversion has expired, the 10% additional tax does not apply.

6. On 3-13-04, $100,000 is withdrawn from Roth IRA #1, and $7,000 from Roth IRA #3.

Discussion. Her annual contribution basis is $14,000, and this is deemed to be distributed first. Then conversion amounts are deemed distributed in order of when converted. The first conversion amount of $60,000 is deemed distributed. Because the five-year period for this conversion has expired, the 10% additional tax does not apply. The second conversion amount of $20,000 is deemed distributed. At the time of distribution she is not yet age 59 1/2; she is only 59. Because the five-year period for this conversion has not expired and because she is not age 59 1/2 or older, the 10% additional tax will apply so that $2,000 will be owed ($20,000 x 10%). The third conversion amount of $36,000 is deemed distributed to the extent of $13,000. Because the five-year period for this conversion has not expired and because she is not yet age 59 1/2, the 10% additional tax will apply so that an additional $1,300 will be owed ($13,000 x 10%).

7. Same situation as in #6 except the distribution takes place a year later on 3-13-05 when she is age 60.

Discussion. In situation #6, the 10% additional recapture tax applied to the withdrawal amounts that were allocated to conversion #2 and conversion #3, because she was not yet age 59 1/2. She is now age 60 and the 10% additional tax

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Separate Roth IRAs —*Continued from page 2*

will not be owed even if the five-year requirement has not been met with respect to conversions #2 and #3.

Summary. The existence of the aggregation rule, the ordering rule and the fact there are no longer separate five-year requirements for inclusion in income purposes leads to the result that there is no longer any reason to keep separate Roth IRAs—one for conversion contributions and another for annual contributions. This is true even though there is a special rule which provides for the recapture of the 10% additional tax in the case of certain "early" distributions from a conversion amount. The recapture rule provides that the rules of Code section 72(t) are to be applied if any portion of a distribution from a Roth IRA (even though it would not normally be taxable because it is a return of basis) derives from a conversion and such distribution occurs within the five-year taxable period generally beginning January 1 of the year of the conversion unless the accountholder is now age 59 1/2 or older.

Like it or not, the Roth IRA accountholder (or his or her tax preparer) is going to be required to keep detailed accounting records (ie. Form 8606) for many years to keep track of the basis of his or her annual contributions, the basis of his or her conversion amounts, his or her earnings, and the effect of any distribution on these basis amounts.

The IRS has indicated that they most likely will be deleting the box (Roth Conv.) in box 6 of the Form 5498 which was used to indicate if the IRA was a Roth Conversion IRA. We expect that they will also delete the concept of the Roth Conversion IRA from the model Roth IRA plan agreement forms in the near future. PD

Does the 10% Additional Tax Apply to NUA?

A person who is not yet age 59 1/2 is considering having his or her distribution from a qualified plan taxed under Code section 402(e)—special rules with respect to net unrealized appreciation (NUA) of employer stock. There are certain rules for a lump-sum distribution and other rules for a distribution other than a lump-sum distribution. At the end of this article is a summary which the IRS has written in Publication 575 about the taxation of net unrealized appreciation in employer securities (Footnote "A"). The general concept is—a pension participant who is distributed employer securities (versus cash) is not presently taxed on the unrealized appreciation of such securities. Tax will be owed when the securities are sold.

Code section 72(t) authorizes the imposition of a 10% additional tax on early distributions from qualified retirement plans.

What is a qualified retirement plan?

Code section 4974(c) sets forth the definition - cites plans or annuities in 401(a), 403(a), 403(b), 408(a) and 408(b).

What is an early distribution?

Actually, the use of the term "early distribution" is a misnomer, but this is the term used in the title of the statute. The actual statutory language provides that EVERY distribution will be subject to an additional 10% tax except for certain defined distributions. There are numerous defined exceptions—some apply only for IRAs, some only for QPs and some for both. The IRS has provided a detailed listing of these exceptions in Publication 575; they are found at the end of this article (Footnote "B").

Note that Code section 72(t) does not expressly provide that the net unrealized appreciation will not be subject to the 10% additional tax.

If the net unrealized appreciation is not subject to the 10% additional tax, it will be because of subsection (t)(1) which reads as follows:

> "If any taxpayer receives any amount from a qualified retirement plan (as defined in section 4974(c)), the taxpayer's tax under this chapter for the taxable year in which such amount is received shall be increased by an amount equal to 10 percent of the portion of such amount which is includible in income."

It is this subsection which provides the authority for the fact that nondeductible employee contributions and distributions which are rolled over are not subject to the 10% additional tax.

The 10% additional tax will apply to the cost basis of the employer stock because that amount is clearly includable in income for the year of distribution.

It is not so clear whether or not the 10% additional tax applies to the net unrealized appreciation in the employer stock.

If the stock is not sold in the year of receipt, then subsection (t)(1) clearly provides that the unrealized appreciation will not be subject to the 10% additional tax for that year.

It is not so clear if the 10% additional tax is owing "for the year of receipt" (i.e. retroactively) if the stock is sold in a year after the year of receipt (and no other exceptions of Code section 72(t) would apply) because such sale most likely will result in gains which will be includable in income at that time. None of the research materials or books I have seen address this issue. They are all silent on the issue. I tend to become nervous when the IRS does not address an issue. The fact that the IRS does not expressly address an issue does not necessarily mean that the IRS is unaware of or has not adopted a position on an issue.

Set forth below is a hypothetical situation which illustrates why I am nervous about a conclusion that the 10% additional tax would never apply. The lost tax revenues could be substantial and consequently, the IRS would be motivated to pursue such revenues.

Mary Hill received a distribution of 1,000 shares of GGG, Inc. stock on 12-10-98. This was employer stock. The cost basis in this stock was $50,000. The fair market value of this stock was $5,000,000. Mary is age 48. She decides to sell the stock on 1-3-00 (or alternatively on 1-3-99).

She will owe the 10% additional tax on the basis of $50,000. Does she avoid paying the 10% excise tax on $4,950,000 (or $495,000) on any sale which occurs after 12-31-98, but during a year when she is not yet age 59 1/2?

Summary. The law is unclear on this subject. Any person will need to consult with his or her tax advisor on this issue. I don't believe the issue has been settled by the IRS. A financial institution would have a hard decision: Does it code the distribution as a "1"(premature and no known exception), or a "2" (premature, but an exception known)? The bank may well want (and need) to ask the IRS for its position on this issue. The client may well wish to seek a private letter ruling.

The purpose of this article was to provide some basic information of this interesting issue.

Footnote "A" — IRS Summary of Distributions of employer securities:

> **Distributions of employer securities.** If your distributions includes securities in the employer's corporation, these securities may have increased in value while they were in the trust. "Securities" includes stocks, bonds, registered debentures, and debentures with interest coupons attached. This increase in value is called "net unrealized appreciation" (NUA).
>
> ***If the distribution is a lump sum,*** you are not taxed on the NUA when you get the

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securities, unless you elect to include it in your gross income in the year received.

If the distribution is not a lump sum, this tax deferral applies only to the extent the NUA in employer securities results from employee contributions. This treatment does not apply to a distribution based on deductible voluntary employee contributions (defined earlier). The NUA on which tax is deferred should be shown in box 6 of the Form 1099-R you receive from the payer of the distribution.

You can choose to be taxed on the NUA before you sell the securities. Make this choice on the tax return on which you have to include the distribution if you choose to be taxed on the NUA and there is an amount in box 3 of the Form 1099-R, part of the NUA will qualify for capital gain treatment. See the instructions for Form 4972.

When you sell or exchange employer securities with untaxed NUA, any gain is ***long-term*** capital gain up to the amount of the NUA. Any gain that is more than the NUA is a long-term or short-term capital gain, depending on how long you held the securities after the distribution.

Holding period for long-term capital gain treatment. If a NUA distribution is made:

• **After May 6, 1997** (and before January 1, 1998), the NUA is treated as long-term capital gain regardless of the actual period that an employer security was held by the qualified plan. However, when you sell or exchange the securities after the distribution, the 20% rate applies to any additional appreciation only if you held the securities for more than 18 months after the distribution. **On or after January 1, 1998,** the 20% long-term rate applies to assets held more than one year. Before May 7, 1997, any gain on assets held for more than one year was considered long-term capital gain.

Losses. If all you receive are worthless securities, you can claim a loss of the plan participant's total contributions to the plan. To do so, you must itemize your deductions on Schedule A (Form 1040) and claim the loss as a miscellaneous deduction (subject to the 2%-of-adjusted-gross-income limit).

You cannot claim a loss if all you receive is stock with a fair market value that is less than the plan participant's total contributions to the plan. You can claim a loss only if you sell or exchange the stock for less than the plan participant's contributions.

Footnote "B" —

Exceptions to tax. The early distribution tax does not apply to distributions that are:

1) Made to you on or after the date on which you reach age 59 1/2,

2) Made to a beneficiary or to the estate of the plan participant or annuity holder on or after his or her death,

3) Made because you are totally and permanently disabled,

4) Made as part of a series of substantially equal periodic (at least annual) payments over your life (or life expectancy) or the joint lives (or joint life expectancies) of you and your beneficiary (if from a qualified employee plan, payments must begin after separation from service),

5) Made to pay for qualified higher education expenses for yourself, your spouse, your children, or grandchildren to the extent that the distribution does not exceed the qualified higher education expenses for the taxable year,

6) Made to pay for a first-time home for yourself, your spouse, your children, your grandchildren, or your ancestors to the extent that the distribution is used by you within 120 days from the date of the distribution,

7) Made to you after you separated from service with your employer if the separation occurred during or after the calendar year in which you reached age 55,

8) Paid to you to the extent you have deductible medical expenses (the amount of medical expenses that exceeds 7.5% of your adjusted gross income), whether or not you itemize deductions for the tax year,

9) Paid to alternate payers under qualified domestic relations orders (QDROs),

10) Made to you if, as of March 1, 1986, you separated from service and began receiving benefits from the qualified plan under a written election that provides a specific schedule of benefit payments,

11) Made to correct excess deferrals, excess contributions, or excess aggregate contributions,

12) Allocable to investment in a deferred annuity contract before August 14, 1982,

13) From an annuity contract under a qualified personal injury settlement,

14) Made under an immediate annuity contract, or

15) Made under a deferred annuity contract purchased by your employer upon the termination of a qualified employee retirement plan or qualified annuity and that is held by your employer until you separate from the service of the employer.

Only exceptions (1) through (6) and (8) apply to distributions from IRAs. Exceptions (7), (9) through (11) apply only to distributions from qualified employee plans. Exceptions (12) through (15) apply only to deferred annuity contracts not purchased by qualified employer plans. PD

Wrong Beneficiary—*Continued from page 1*

reversed; under Minnesota trust law, the IRA trustee maintained an interest in the IRA funds even though they had been distributed because they had been distributed to the wrong party. We would hope all courts will adopt this approach. PD

✔ Check It Out

Question #1. Is each beneficiary required to take a required minimum distribution?

Paula Mylan died at age 74 with a traditional IRA balance of $45,000. Her two children, Donald and Maria, were her beneficiaries. Each inherited a 50% share. Her required minimum distribution (RMD) amount for 1998 was $3,000 and was not distributed prior to her death. If Donald wishes to withdraw his entire $22,500, can Maria skip taking her share of the RMD ($1500) because Donald took much more than was required? Or, is each beneficiary required to take a required minimum distribution?

✓ Answer. Each beneficiary is required to receive a required distribution. We believe that there is a pro rata allocation of all "tax incidents" to an IRA beneficiary of a traditional IRA —pro rata share of nondeductible/basis/ taxable ratios, pro rata share of any required minimum distribution and pro rata share of any other tax incident. The IRS has certainly adopted this approach with respect to the Roth IRA in the Roth IRA regulations.

You asked for the authority for this conclusion. I admit what I have is somewhat limited, but here it is. When an IRA accountholder dies, it is clear that an identifiable "inherited" IRA needs to be established for each beneficiary, at least from an accounting standpoint. Although the proposed regulation does not address this subject, the instructions for the Form 5498 do. The IRS' instructions for the Form 5498 state that an IRA trustee must prepare a "separate" Form 5498 for each beneficiary. The regulation does recognize the right of multiple beneficiaries to each make their own distribution election if the IRA accountholder dies before his or her required beginning date. That is, one beneficiary may elect the five-year rule whereas a different beneficiary may elect the life-distribution rule. Regulation 1.401(a)(9)-lC-4(2)(c) expressly allows a plan to give beneficiaries the right to elect on an individual basis between the five-year rule and the life-distribution rule (i.e. the exception to the five-year rule). This section is enclosed. Also, see H-2 as enclosed. 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.