THE Pension Digest

February, 1999
Published Since 1984

ALSO IN THIS ISSUE –

FINAL ROTH IRA REGULATIONS

The IRS has issued final Roth IRA regulations. They are effective February 3, 1999. The August 1998 newsletter discussed in detail the proposed regulations. This article summarizes the clarifications and changes made in the final regulations. There are separate articles discussing the changes with respect to recharacterizations, reconversions and conversion deadlines.

1. Code section 408(d)(5) sets forth a tax-free withdrawal rule for the withdrawing of excess contributions from a traditional IRA after the due date for the tax return for which the contribution was made; but certain conditions must be met. The IRS has adopted the position that Code section 408(d)(5) does not apply to Roth IRAs because any withdrawal of basis (i.e. contributions) is tax free. However, in some situations there may be acceleration of income inclusion because of the rules related to an early distribution related to the four-year spread rules.

2. Code section 219(f)(6) provides that an excess contribution to a traditional IRA is automatically converted to an annual contribution for the current year or subsequent year to the extent the taxpayer is eligible to make a contribution. The IRS tends to ignore this section in its administration of the IRA laws. Since the 1986 enactment of the deductibility limits, it has been unclear whether there is a deemed contribution even for those accountholders who would not be eligible to deduct the automatically converted contribution. With respect to the Roth IRA, the IRS has adopted the position that because section 219(f)(6) deals with the deductibility of excess traditional IRA contributions in subsequent taxable years, it has no application to Roth IRAs because contributions to Roth IRAs are never deductible. The adoption of this position strongly implies that Code section 219(f)(6) does not apply to an IRA accountholder who would not be eligible to deduct his or her automatically converted contribution.

3. If recharacterizations and reconversions are made with the same trustee, then such transactions may be made by redesignating or readopting the prior plan/account rather than having to open a new account/plan or annuity. Forms will need to be revised and designed to accomplish this task. Most likely many IRA forms vendors will create an IRA booklet which will contain both the traditional IRA and the Roth IRA and the individual could adopt/create one or both types of IRAs.

4. Contributions to an Education IRA do not in any way affect the amount which an individual can contribute to

Continue on page 8

NEW LIMITS ON ROTH IRA RECONVERSION CONTRIBUTIONS

The final Roth IRA regulation changes in some important ways certain rules or limits on Roth IRA reconversion contributions.

A reconversion is any conversion (i.e. movement from a traditional IRA to a Roth IRA) other than the first conversion occurring after there has been a recharacterization. The final Roth IRA regulations continue the interim rules of Notice 98-50 for 1998 and 1999, but change the rules for 2000 and subsequent years in some important ways. The IRS has decided to not be as lenient in allowing reconversions in the year 2000 and subsequent years as they were in Notice 98-50.

In Notice 98-50, the IRS furnished interim rules which created some limits as to how often a conversion amount could be reconverted. Prior to the IRS issuing this Notice, many in the investment industry were informing IRA accountholders that they could do as many conversions as they wanted and that the tax consequences for 1998 would be based on the last reconversion. In Notice 98-50, the IRS decided to limit the number of permissible reconversions for 1998 and 1999.

Continue on page 2

New Limits on Roth
Continued from page 1

Before discussing the existing rules and the new rules, it is important to understand the overriding concept of the limits applying to conversions and reconversions. As was discussed in the October 1998 newsletter, the conversion and reconversion limits apply on a "per amount" basis and not on a "per account" or a "per accountholder" basis. Thus, if there was $90,000 in an IRA and the accountholder converts $40,000, later recharacterizes it, and then wishes to reconvert the "adjusted" amount, the accountholder is still eligible to convert the remaining amount of $50,000 because that amount has not yet been converted. The IRS could have changed this concept or rule, but they did not.

What waiting period rules and limits apply 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 count towards the limit of one.

Observations. In general, the rules for 1998 and 1999 allow the conversion and the reconversion to happen in the same year. This is not the rule for the year 2000 and subsequent years, as is explained below.

What is meant by the terms, an excess reconversion and a failed conversion? What special rules apply?

These terms have somewhat similar meanings, but there are important differences. An excess reconversion is a term used for 1998/1999 and a failed conversion is a term used for 2000 and subsequent years.

An excess reconversion is a reconversion made during 1998 or 1999 for which the IRA owner was not eligible.

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).

Observation. The IRS actually allowed multiple reconversions within the same tax year, but only the first one determined the amount of the distribution which must be included in income. This is not the rule for the year 2000 and subsequent years, as is explained below.

Revised Reconversion Rules for Year 2000 and Onward

A reconversion taking place after December 31, 1999, is permissible only if it occurs after the beginning of the next taxable year (generally this is after December 31 of the year in which the conversion occurred) or, if later, the end of the 30-day period beginning on the day on which the IRA owner transfers the amount from the Roth IRA back to a traditional IRA by means of a recharacterization (regardless of whether the recharacterization occurs the same year as the conversion or the following year. The following examples illustrate the new rule.

Example # 1. Joni Dow converted $40,000 of her $70,000 traditional IRA on February 3, 2000. On August 10, 2000, she recharacterizes this conversion contribution. She is not eligible to reconvert this amount until January 1, 2001.

Example #2. Elliot Berry converts $25,000 of his $33,000 traditional IRA on April 14, 2000. On December 27, 2000, he recharacterizes this conversion contribution. He is not eligible to reconvert until January 25, 2001, since he must wait at least 30 days.

Example #3. Rex Lardner converts $35,000 of his $53,000 traditional IRA on April 14, 2000. On October 15, 2001, he recharacterizes this conversion contribution. He is not eligible to reconvert until November 14, 2001, since he must wait at least 30 days.

A "failed conversion" is a term which applies for the year 2000 and subsequent years. A "failed conversion" is a reconversion which is made before the above waiting period rules permit. That is, the reconversion occurs before the later of the beginning of the next taxable year after the conversion or the end of the 30-day period that begins on the day of the recharacterization of the conversion. A failed conversion means there has been a distribution from the traditional IRA and there has been a regular contribution to a Roth IRA. Most likely there is an excess contribution that will need to be corrected either by withdrawal or by recharacterization. There are two types of failed conversions - those which will be considered to be a conversion so that they count against the reconversion limit (i.e. the determination of when an IRA owner may make a reconversion) and those which will not count against the reconversion limit. A failed conversion which counts against the reconversion limit occurs when the

Continue on page 3

The Pension Digest

New Limits on Roth
Continued from page 2

statutory requirements of less than $100,000 of income or the filing of a joint income tax return have not been satisfied.

Example #4. Pat Blaskower converts $42,000 on 7-7-2000. She recharacterizes this conversion contribution on 1-18-2001 because she has income of $105,000. Because the statutory requirements were not met, the failed conversion is still counted as a conversion for the purpose of determining when she can make a reconversion. The "deemed" conversion occurred in 2000, so the first day of the next tax year is 1-1-2001. But the 30th day after the recharacterization is 2-17-2001, and because it is later, this day is the earliest she can make a reconversion.

Example #5. Same situation as set forth in Example #4 except Pat mistakenly attempts to reconvert on 1-22-2001. This is clearly a failed conversion. The required "waiting period" has not been satisfied. Because this failed reconversion is not on account of the statutory failings, it does not count as a conversion. The practical effect of it not counting against the limit is that Pat could transfer the amount back to her traditional IRA via a recharacterization and wait until on or after 2-17-2001 to reconvert it.

Example #6. Same situation as set forth in Example #5 except Pat reconverts on 2-28-2001 (i.e. after 2-17-2001). Pat has complied with the "waiting period" requirement. She has the right to recharacterize this reconversion if she would so choose. Let's assume she recharacterizes on October 15, 2002. Note: Pat cannot reconvert this amount until the waiting period requirement has been met. This would be 1-1-2002.

Conclusion. There are new waiting period limit rules for reconversions occurring in the year 2000 and subsequent years. These new rules do not allow reconversions to be done as frequently by taxpayers as under the 1998/1999 interim rules. Such a change was to be expected by the IRS since taxpayers will primarily use reconversions to decrease the amount of their tax liability. And these lower tax collections will be permanent since qualified distributions from Roth IRAs will never be taxed. ◆

UNDERSTANDING THE PRACTICAL ASPECTS OF RECHARACTERIZATIONS

An IRA accountholder will use one of two procedures or options to correct or undo a traditional or Roth IRA contribution when it suits his or her purpose. The first procedure to correct or undo a contribution is to use the rules of Code section 408(d)(4) which allow the withdrawal of a current-year or excess contribution before the due date of the current-year's tax return plus extensions. This procedure requires the withdrawal of the related income, so some taxes will be owed. In some "mistake" situations, the withdrawal option will be the only option. The second procedure or option is to correct or undo the contribution using recharacterization rules. The advantage the recharacterization rules have over the excess contribution rules is that the related income is not required to be withdrawn. Once IRA accountholders become knowledgeable, they will instruct you that they wish to recharacterize versus using the current-year/excess contribution rules.

Most likely, you, as an IRA custodian/trustee, are going to dislike the concept of *recharacterizations* for the reasons discussed below. Nevertheless, you must come to understand well the *recharacterization* rules because we believe they must be available to an IRA accountholder and cannot be curtailed by the IRA custodian/trustee in its IRA Plan Agreement. The law mandates the availability of *recharacterizations*. We have no doubt this right must be explained in the IRA Disclosure Statement for both new and existing IRA accountholders. This is one of the primary reasons an IRA Disclosure Statement needs to be furnished to existing traditional IRA accountholders.

Recharacterization—it is such a nice simple concept—a person can change the type of his or her IRA contribution simply by furnishing a written instruction to one or two IRA custodians/trustees. The problems appears to be—*recharacterizations* are going to be very burdensome from an IRS reporting standpoint and labor intensive from the IRA custodian/trustee standpoint. *Recharacterizations* are not simple. The guidance which the IRS has given so far does not seem to be sufficient at this point because the IRS' instructions fail to handle the current-year/prior-year concepts. As will be explained later, there most likely are very few, if any, data processing systems designed to do what the IRS says they want done.

You may wish to review some prior articles on *recharacterizations*. The September 1998 newsletter had two articles on *recharacterizations:* (1) *Detailed Explanation—Recharacterize Contributions,* and (2) *Notice 98-49 Reporting for Recharacterized Contributions.* The January newsletter had a detailed discussion of how and when to complete the 1998 Form 8606. If there is a recharacterization, the IRA accountholder must complete and file the Form 8606.

The purpose of this article is to provide additional discussion and information so that you, as an IRA custodian/trustee, can decide what assistance, if any, you wish to give to your customer. Although the IRA custodian/trustee must prepare reporting forms, the Form 8606 must be filed by the individual. The instructions for the Form 8606 require the individual to attach an explanation detailing the tax consequences of one or more *recharacterizations.*

A typical recharacterization situation is the following one. On November 1, 1998, Nancy Clark, age 61, converts $45,000 from her traditional IRA to a Roth IRA. This conversion happened with the same IRA custodian, Sixth State Bank. Nancy is unmarried. She has modified adjusted gross income of $102,000; there

Continue on page 4

Practical Aspects
Continued from page 3

have been related earnings of $2,300. Today, February 15, 1999, Nancy has furnished you a written instruction to recharacterize the contribution because she knows she did not meet the eligibility requirements. Nancy completed a "Recharacterization Instruction Form." A sample of such a form is enclosed. Note the conversion contribution occurred in 1998, and the recharacterization in 1999.

The only reporting form which you, as the IRA custodian/trustee, should have prepared and furnished so far in 1999 is the 1998 Form 1099-R for the conversion. There was a deemed distribution of $45,000, and $45,000 is inserted in both boxes 1 and 2a of the Form 1099-R. The reason code is a 7 because Nancy is age 61. You will be preparing a Form 5498 due in May which will report the conversion contribution in box 3 of the 1998 Form 5498. You do not change or correct the reporting for the conversion transaction in any way, because she now wishes to undo the conversion via a recharacterization.

But what does the IRA custodian/trustee do with respect to Nancy's recharacterization which occurs in 1999, but really applies to the 1998 tax year?

A 1999 Form 1099-R will be completed to handle the "deemed distribution" from the Roth IRA back to the traditional IRA. Box 1 is to be completed with the gross amount of $47,300 (conversion amount plus earnings). Box 2a is to be completed with a zero. The reason code in box 7 is to be an "R" (Recharacterization). A 1999 Form 1099-R is prepared because the recharacterization happens in 1999, even though it applies to the 1998 tax year. The reporting form will be furnished a year late, as happens with the withdrawal of an excess contribution. CWF's comment: Example #1 on pages 3 and 4 of the instructions for the 1998 Form 8606 might be read to imply that the IRA custodian/trustee must prepare a 1998 Form 1099-R even though the recharacterization decision is not made until March of 1999. As mentioned earlier, a recharacterization in some ways is similar to the withdrawal of an excess contribution. There are two reporting codes for the withdrawal of excess contributions. We expect the IRS will adopt two reporting codes, possibly an R (a current-year recharacterization) and an RP (a prior-year recharacterization), but they have not done so yet. We strongly suggest that you, as the IRA custodian/trustee, furnish a special notice to Nancy Clark informing her that she will need to complete the Form 8606 for her recharacterization and she will need to attach an explanation of the tax result of her recharacterization. We suggest this because it is good customer service and because the IRS instructions for the Form 1099-R suggest that a notice be furnished when there is a withdrawal of an excess contribution. The recharacterization situation is very similar and therefore the special notice should be furnished.

A 1999 Form 5498 will be completed to handle the recharacterized conversion contribution to the traditional IRA from the Roth IRA. It is reported as a rollover on a "special" Form 5498. See the discussion in the September newsletter. Again, the form will be furnished a year late.

We suggest you, as the IRA custodian/trustee, furnish an explanation similar to the following:

"On February 15, 1999, you instructed us to recharacterize your conversion contribution of $45,000 which you converted on _____. RECHARACTERIZATIONS are complex and you most likely will want the assistance of your tax advisor to complete your income tax return. As you know, your conversion occurred in 1998 and your recharacterization occurred in 1999.

The net effect of your recharacterization is that for federal income tax purposes, you are to treat the conversion as never having taken place. You will not have to include any amount in income because of your conversion and your un-doing of your conversion.

The instructions for the 1998 Form 8606 instruct a person who has made a recharacterized contribution to insert on line 15a of Form 1040 the gross amount distributed from all your IRAs. $92,300 is the combined amount from your conversion distribution of $45,000 plus the deemed distribution from the Roth IRA of $47,500. Then you are to insert a "0" on line 15b because you have no taxable income related to your conversion since you recharacterized it.

You are advised that the IRS wants you to attach a note to your Form 8606 explaining to them what has happened—describe the original conversion contribution by giving the date and amount, the amount of the related earnings which have been transferred back to the traditional IRA and the fact that there is no taxable income. You may wish to rewrite this note which we have furnished you and attach it to your Form 1040 as the explanation which the IRS wishes to be furnished.

You should refer to the various examples on pages 3 and 4 of the instructions for the Form 8606 for guidance how to properly report on your tax forms the conversion and the recharacterization. You should confirm what you do with your tax advisor.

Please contact us if we can provide you with further assistance on your recharacterization.

Sincerely,

IRA Custodian/Trustee"

Conclusion. *Recharacterizations* are very complicated for all parties concerned—the IRA custodian/trustee, the accountholders and the IRS. Hopefully, the IRS will improve their guidance in 1999. Any IRA accountholder who chooses to do a recharacterization must understand that he or she will be required to file the Form 8606 and attach a statement explaining the recharacterization transactions and the net tax effects. You, as the IRA custodian/trustee, should advise your IRA accountholder of this filing and explanation requirement. ◆

The Pension Digest

REVISITING MSAs

Medical Savings Accounts (MSAs) are designed to encourage employees to save for medical expenses they may face. MSAs are available to self-employed individuals and employees of "small employers" (50 or less) who participate in "high-deductible health plans." They are also available to the spouses of the employees.

A high-deductible insurance plan must be sponsored by the employer in order for the individual to be eligible for an MSA. The high-deductible plan can be offered through a health maintenance organization (HMO) or through an employer-sponsored cafeteria plan. The employee is not eligible if they have additional health care coverage other than another high-deductible plan, or specialty coverage such as insurance for accidents, disability, dental or vision care, etc.

The 1999 limitations for the high-deductible plan are shown here:

Individual Coverage – The minimum deductible is $1,550 and the maximum is $2,300. The maximum out-of-pocket limitation is $3,050. (Out-of-pocket means the total of their deductibles: co-payments and other amounts the participant must pay for covered benefits, except premiums.)

Family Coverage – The minimum deductible is $3,050 and the maximum is $4,600. The maximum out-of-pocket limitation is $5,600.

An eligible individual will receive a tax deduction for the contribution that they make to an MSA. The contribution and deduction is limited to 65% of the annual deductible under the plan for a person with individual coverage, and 75% of the annual deductible under the plan for a person who has family coverage. These amounts must be prorated if the person did not participate in the high-deductible plan for the entire year.

If the employer makes a contribution to the employee's MSA, the amount of the employer's contribution is not includible in income, nor is it subject to income tax withholding or other employment taxes. The employer will receive a tax deduction for the amount of the eligible contribution. If an employer makes a contribution for any employee, he must contribute the same amount or same percentage for all employees. Also, if the employer makes MSA contributions for its employees, the individual employees are not permitted to make any MSA contributions for themselves.

Earnings on MSA accounts are not included in income in the year earned.

Distributions can occur at any time. If the distribution is used for a medical expense that would qualify as a deductible item on an individual's 1040 Schedule A, it is considered a "qualified medical expense."

Distributions used for a purpose other than a qualified medical expense will be considered a nonqualified distribution and will be taxed. In addition, nonqualified distributions will be subject to a 15% penalty tax unless the distribution is made after age 65 or because of the accountholder's death or disability.

MSAs are currently considered a "test project," and the legislation creating them placed a limit of 750,000 MSA participants. Once this figure is reached, no more MSAs can be established until such time as the government decides to expand the program. At this time we are below the estimated amount.

Form 8851 is used to furnish information about MSAs to Congress and to determine when the maximum number of MSAs allowed by law is reached. The form reports the total number of MSAs established for a particular time period, the total number of previously uninsured accountholders, the total number of excludable accountholders and the names and social security numbers of accountholders. The custodian/trustee files this form by August 2, 1999, to cover the period from January 1 through June 30, 1999.

One of the tax advantages of MSAs is that there is no negative "use or lose" factor. If the funds are not fully used for qualified medical expenses, the funds will not necessarily be penalized. If the unused funds are not distributed until the accountholder attains the age of 65, has died, or becomes disabled, only tax will be assessed. There will be no additional penalty incurred. ◆

A SPECIAL SEPP RULING

It was bound to happen, especially with the way the stock market has performed. A person sets up a substantially equal periodic payment (SEPP) schedule, receives distributions for a few years, and then decides, for any number of reasons, to terminate the first schedule (knowing he or she must pay the 10% additional tax on all distributions to date) and establish a second schedule to apply to future distributions.

Does the IRS allow this approach or does the IRS take the position that once a schedule is set up, it cannot be modified until the later of age 59½ or being in effect for five years?

The IRS addressed a number of these issues in PLR 19990959. In 1990, the taxpayer rolled over $1,000,000 into an IRA. The $1,000,000 came from his previous employer's qualified plan. The taxpayer self-directed the IRA. The IRA's account balance as of 12-31-92 was $2,582,180. The taxpayer, in January of 1993, established a SEPP schedule. The taxpayer elected to use the 401(a)(9) method. He was age 44. He also elected to use the joint and survivor life expectancy using the age of his wife to calculate a joint factor of 44.6 years. An earnings rate of 6.8% was used. The annual payment has been $176,499.

The taxpayer had invested very well. The IRA's account balance as of 12-31-97 had increased to $9,191,399. He came to the conclusion that he

Continue on page 8

✓ CHECK IT OUT

Situation. Ted Andrews is at your desk. He had compensation of $94,000 in 1998. He is age 63. Earlier in the year a $2,000 contribution had been made into his wife's traditional IRA. She does not have any compensation. They will file a joint income tax return. He is an active participant in an employer-sponsored plan. His accountant (or his Turbo Tax software) has instructed him to withdraw $260 from his wife's traditional IRA because it is nondeductible. Their modified adjusted gross income is $151,315. The contribution amount eligible to be deducted on her behalf is $1,740. He has a valid power of attorney from his wife allowing him to make withdrawals and contributions with respect to his spouse's IRA. He has decided to withdraw $300 of the $2,000 contribution for 1998 from his wife's traditional IRA. Neither of them did a Roth conversion in 1998.

Question. What amount may be contributed for 1998 to her Roth IRA?

✓ **Answer.** $300. The maximum combined contribution which she can make to both IRAs is $2,000. Contributions are first allocated to the traditional IRA. She is eligible to contribute the full $2,000 to the traditional IRA since Ted has sufficient compensation to justify each of them having a $2,000 contribution.

She would be eligible to deduct a contribution of $1,740 calculated as follows:

$$\frac{(\$151{,}315 - \$150{,}000)}{\$10{,}000} = 13.15\% = \text{nondeductible percentage}$$

$2,000 x 13.15% = $263 (but round to $260) = nondeductible portion

$2,000 - $260 = $1,740 = deductible portion

But he, on her (their) behalf, has decided that she will contribute only $1,700 to her traditional IRA.

A special rule applies when she has made (or will make) contributions to both a Roth IRA and a traditional IRA. The contribution limit for the Roth IRA is the lesser of: (1) her maximum contribution limit (in this case $2,000) as reduced by the amount she contributed to a traditional IRA (in this case $1,700) or $300 or (2) the maximum contribution allowed her after applying the pro rata calculation formula as set forth below:

$$\frac{(\$151{,}315 - \$150{,}000)}{\$10{,}000} = 13.15\% = \text{noneligible percentage}$$

$2,000 x 13.15% = $263 (but round to $260) = noneligible portion

$2,000 - $260 = $1,740 = eligible contribution amount for the Roth

Since the $300 is less, this is her permissible Roth IRA contribution. Note that the calculation for the permissible Roth calculation is not: $1,740 (maximum permissible amount as calculated using the formula) less the amount (i.e. $1,700) contributed to the traditional IRA or $40.

Question. What amount may be contribute for 1998 to his traditional IRA?

✓ **Answer.** $2,000.

Question. What portion of his contribution qualifies to be deducted?

✓ **Answer.** $0.00. He is an active participant, and their modified adjusted gross income exceeds the phaseout/eligibility limit of $60,000.

Question. What amount is he eligible to contribute to a Roth IRA?

✓ **Answer.** He is eligible to contribute $1,740, assuming he did not contribute more than $260 to his traditional IRA. The same formula which was used to calculate her Roth contribution is used to calculate his:

$$\frac{(\$151{,}315 - \$150{,}000)}{\$10{,}000} = 13.15\% = \text{noneligible percentage}$$

$2,000 x 13.15% = $263 (but round to $260) = noneligible portion

$2,000 - $260 = $1,740 = eligible contribution amount for the Roth

Question. Is the deadline for 1998 conversion contributions December 31, 1998, or April 15, 1999?

✓ **Answer.** We believe the deadline for 1998 conversion contributions is December 31, 1998.

General Discussion. CCH, Inc., a major publisher of legal research materials, has written, "Conversions for the 1998 tax year can be made as late as April 15, 1999 or any extended due dates." And CCH, Inc. has also written, "The time machine also starts at the beginning of 1998 for those who convert to a Roth IRA by April 15, 1999 plus extensions."

We do not agree with CCH that April 15 is the deadline for 1998 conversion contributions.

We believe the source of confusion is Internal Revenue Code section 408A(c) – Treatment of Contributions. This section has the following subsections:

(1) No Deduction Allowed

(2) Contribution Limit

(3) Limits Based on Modified Adjusted Gross Income

(4) Contributions Permitted After Age 70 1/2

(5) Mandatory Distribution Rules Not to Apply Before Death

(6) Rollover Contributions

(7) Time When Contributions Made

Code section 408A(d)(3)(C) defines a conversion to be a rollover.

We believe the source of confusion is subsection (7). It reads:

"(7) Time When Contributions Deemed Made - For purposes of this section, the rules of Code section 219(f)(3) shall apply.

Code section 219(f)(3) reads,

"(3) Time When Contributions Are Deemed Made. - For purposes of this section, a taxpayer shall be deemed to have made a contribution to an individual retirement plan on the last day of the preceding taxable year if the contribution is made on account of such taxable year and is made not later than the time prescribed by law for filing the return for such taxable year (and not including extension thereof).

Many times, the term "carryback" is used to define those contributions made in one tax year which are designated for the prior tax year.

Continue on page 7

The Pension Digest

✓ Check it Out
Continued from page 6

Based on the literal language of the section, an argument can be made that the rules of 219(f)(3) are to apply to rollover contributions as well as annual contributions. Subsection (7) is not expressly limited to the annual contributions. It seems to cover all contributions, annual and rollover.

For the following reasons, we do not believe, however, that subsection (7) applies to conversion/rollover contributions from a traditional IRA to a Roth IRA.

1. We have not seen the IRS, in any of their written guidance, state the April 15 deadline for conversion contributions. The Final Roth IRA Regulation and the 1998 IRS Publication 590 do not contain any discussion on the timing deadline for conversion contributions. Nor do the instructions for Form 5498 instruct the IRA custodian that it is possible that an IRA depositor may somehow make a conversion contribution in 1999 which is really for 1998.

2. The purpose of Code section 219 is to define the rules (eligibility, contribution limits, deadline, etc.) for annual contributions to a traditional IRA. There is no discussion of rollover rules in Code section 219. The April 15 rule applies to annual contributions and not rollover contributions.

3. Under the Internal Revenue Code, rollovers have always been analyzed on a calendar-year basis. The normal situation is that the distribution and the rollover contribution take place within the same year. There is a Form 1099-R prepared to report the distribution and a Form 5498 prepared to report the rollover contribution, but the person does not have to include any rolled over amount in income because the purpose of the rollover laws is to allow continual deferral of the tax-favored dollars. Administratively, it would be very confusing to consider any type of rollover on a "carryback" basis. It is certainly possible, though, that the IRA distribution occurs in 1998, but the rollover contribution occurs in 1999. The Form 1099-R, which must be prepared to report the distribution is the 1998 Form 1099-R and the Form 5498 which must be prepared to report the 1999 rollover contribution is the 1999 Form 5498. A prudent taxpayer in this situation will attach a note to his or her 1998 and 1999 tax return explaining how the transactions affected both tax years.

4. The IRS has written special rules for recharacterizations and reconversions. These are related concepts but they are very different.

In a recharacterization, the money may flow (or be deemed to flow) from a traditional IRA to a Roth IRA or vice versa. The deadline for completing a recharacterization is the tax-filing deadline (with extensions) for the individual's taxable year FOR WHICH the regular contribution is made to a Roth IRA of the individual or the tax-filing deadline (with extensions) for the individual's taxable year IN WHICH the conversion contribution is made to any Roth IRA. The general deadline is April 15 plus extensions.

In a reconversion (or a conversion) the money may flow (or be deemed to flow) always from a traditional IRA "to" a Roth IRA. There is no vice versa. There really is no time deadline by which a reconversion must be completed. There certainly are rules as to when a person is eligible to do a reconversion. If an individual wants a reconversion done for a certain tax year, it must be done by December 31.

We believe the IRS has concluded that for administrative reasons (i.e. reporting reasons) they need to maintain the approach of reporting rollovers (and now conversions and reconversions) on an annual basis and not on a tax-year or carryback basis. Recharacterizations, however, do apply on a tax-year basis.

Discussion of Federal Income Tax Consequences

The primary tax consequence of converting an amount in a traditional IRA to a Roth IRA is the requirement to include the conversion amount in gross income for the year ***in which*** the amount is distributed (i.e. an actual rollover) or is deemed distributed (i.e. a conversion via a transfer). The general IRA distribution and taxation rules of Code section 408(d)(1) and (2) apply. Thus, if any portion of the distribution is the return of nondeductible basis, then this basis is not included in gross income.

There is a major exception to this rule. Code section 408(d)(3)(A)(iii) reads as follows:

> "unless the taxpayer elects not to have this clause apply for any taxable year, any amount required to be included in gross income for such taxable year by reason of this paragraph for any distribution before January 1, 1999, shall be so included ratably over the 4 taxable year period beginning with such taxable year."

The consequence is—if the conversion occurred on or before December 31, 1998, then the converter/taxpayer includes in gross income for 1998 only 25% of the conversion amount and 25% for 1999, 2000, and 2001 unless the taxpayer/converter expressly elects to include the entire distribution in income.

The IRS decided there needed to be an exception to the exception. So, the IRS, in the Roth IRA regulation, adopted a special rule—100% of the conversion amount must be included for all other calculations requiring the calculation of adjusted gross income or modified adjusted gross income. The IRS gave some examples in the regulation. "It is counted for purposes of determining the taxable portion of social security payments under section 86 and for purposes of determining the phaseout of the $25,000 exemption under section 469(i) relating to the disallowance of passive activity losses from rental real estate activities." The effect of the IRS' special rule is that the IRS will collect more tax dollars than it otherwise would have because a taxpayer will pay more taxes because 100% of the conversion amount is considered as income for other tax calculation purposes even though the statute clearly states that only 25% is to be included in gross income for each of the four years, including the first year.

We believe the IRS' authority for its special rule is very questionable. Some taxpayers may find it worthwhile to litigate this issue.

Continue on page 8

The Pension Digest

✓ Check it Out
Continued from page 7

With respect to the question of when does the 5 taxable year period begin and end, the final regulation reads, "The 5 taxable year period begins on the first day of the individual's taxable year FOR WHICH the first regular contribution is made to a Roth IRA of the individual or, if earlier, the first day of the individual's taxable year IN WHICH the first conversion contribution is made to any Roth IRA of the individual."

Summary. Although Code section subsection 408A(c)(7) could be read as authorizing the carryback contribution concept for Roth rollovers, we do not think the IRS will ever adopt this approach and we do not believe it is the correct approach. December 31, 1998, is still the deadline for 1998 conversions and reconversions and December 31, 1999, is still the deadline for 1999 conversions and reconversions. ◆

Final Roth Regulations
Continued from page 1

his or her traditional IRA and/or Roth IRA.

5. Only individuals are eligible to make Roth IRA contributions. They must have compensation and must not have too much compensation. Children are eligible to make Roth IRA contributions to their Roth IRA as any other individual as long as they have compensation, but not too much compensation. How such IRAs must be established is a matter of state law. CWF's position for minors and traditional IRAs has always been that we see no problem with a minor signing a "deposit" type IRA plan agreement because most states have laws which provide that contracts signed by minors are voidable at their election. We don't see the IRA custodian being harmed if a minor chooses to "void" a deposit IRA. However, if the minor wishes to have a self-directed IRA, the position of CWF has always been that a parent or guardian must be required to sign because that is the only way the risk of the investment performance will rest with the child (parent) and not the financial institution.

6. Many taxpayers will have elected to use the four-year spread method for 1998 conversions. One of the eligibility requirements is that a person, if married, must file a joint income tax return. It was unclear what happened if in 1999-2001 a person would file a separate return or would be divorced. The IRS has adopted the position that a person may continue to apply the four-year spread method even if a change in filing status or a divorce occurs.

7. The proposed regulation provided the rule—a surviving spouse is entitled to continue the four-year spread (and need not accelerate the remainder in income for the year of death) only if the surviving spouse is the sole beneficiary of all of the deceased spouse's Roth IRAs. The IRS explained why they were not willing to change this rule. With respect to inherited IRAs, the IRS has consistently followed the approach that the "tax incidents" of the decedent's IRA pass through to his or her beneficiary(ies) on a pro rata basis. The policy of the Roth law is that only a surviving spouse beneficiary has the right to continue the four-year spread method. This rule is violated if the four-year spread can be passed to other beneficiaries. Because of the Roth ordering distribution/taxation rules, the only way to not violate the rule against having nonspouse beneficiaries be able to use the four-year spread method is to require that the spouse be the beneficiary of all Roth IRAs, even the ones for which the decedent did not elect to spread, or established after he or she had done a conversion which had been spread.

8. People are still looking for ways around the rule that required minimum distributions (RMDs) cannot be rolled over or converted to a Roth IRA. The IRS is not backing away from the RMD rules as set forth in the RMD proposed regulations. There is still the rule that the first amount distributed (and all conversions are a type of distribution) during a calendar year is treated as the RMD if the RMD requirement has not yet been met. Thus, RMDs of a traditional IRA may never be converted to a Roth IRA.

An IRA/pension consulting company has adopted the position that RMDs may be transferred from one traditional IRA to another traditional IRA. We are not sure what authority this company has for this position because the IRS has never stated this position in any public way. The governing proposed regulation says a taxpayer will owe the 50% excise tax if he or she transfers an RMD amount. The IRS' most recent "public" statements on the RMD topic in the Roth regulation do not seem to forecast a change in the RMD transfer rule. ◆

Special SEPP Ruling
Continued from page 5

was not happy with the annual payment of $176,499. He wanted more, but he didn't want to owe the 10% additional tax with respect to future distributions.

He proposed to the IRS the following. First, he wanted to terminate the existing schedule. He was very willing to pay the 10% additional tax, plus interest, on the 1993-1997 distributions. Second, he wanted to now use a modified version of either the section 401(a)(9) method or the amortization method as described in Notice 89-25.

The modification was—he wanted to use the following formula to calculate the annual payment for each year. The account balance for each year will be determined as of the third Monday of each January or the next day on which the securities markets are open. This amount will be amortized ***each year*** by using a single life-expectancy factor of 33 and a constant earnings rate of 7.2%. He was age 49 in 1998. The factor of 33.0 will be reduced by one for each subsequent year. Note that under this method, the annual payment will change from year to year. If the IRA's fair market value continues to increase, so will the annual payment amount.

The IRS ruled this proposed schedule results in a substantially equal periodic payment. The 10% additional tax Code section 72(t) will not apply unless this schedule would be impermissibly modified for purposes of section 72(t)(4). ◆