

MEMO# 10700

February 4, 1999

IRS RELEASES FINAL REGULATIONS ON ROTH IRAS

1 See Institute Memorandum to Pension Members No. 56-98 and Transfer Agent Advisory Committee No. 54- 98, dated September 1, 1998. [10700] February 4, 1999 TO: PENSION MEMBERS No. 9-99 PENSION OPERATIONS ADVISORY COMMITTEE No. 8-99 TRANSFER AGENT ADVISORY COMMITTEE No. 14-99 RE: IRS RELEASES FINAL REGULATIONS ON ROTH IRAS _____ The

Internal Revenue Service has released final regulations on the Roth IRA. Although the final regulations are effective on February 3, 1999, they are applicable to taxable years beginning on or after January 1, 1998, the effective date for the Roth IRA. The final regulations retain the general structure and substance of the proposed regulations.¹ The following represent issues highlighted in the final regulations, including IRS responses to comment letters received and the December, 1998 hearing on Roth IRA issues. General Provisions/Establishment of Roth IRAs ! Minor child: a Roth IRA may be established for the benefit of a minor child or other person lacking legal capacity to act on his or her behalf. For example, a parent or guardian may establish a Roth IRA on behalf of the minor child. However, the compensation requirements of section 408A(c) must be satisfied. Regular Contributions ! Excess contributions: excess contributions to Roth IRAs may be applied, on a year-by-year basis, against the annual limit for regular contributions to the extent that the Roth IRA owner is eligible to make regular Roth IRA contributions for a taxable year but does not otherwise do so. ! Tax-free distribution of excess traditional IRA contributions after the due date of the tax return: the rules under section 408(d)(5) for the tax-free distribution of certain excess traditional IRA contributions after the due date of the IRA owner's federal tax return do not apply to Roth IRAs because Roth IRA contributions are always tax-free on distribution (except to the extent that they accelerate income inclusion under the 4-year spread). 2! Applicability of section 219(f)(6): section 219(f)(6), which provides for the deductibility of excess traditional IRA contributions in subsequent taxable years, has no application to Roth IRAs because contributions to Roth IRAs are never deductible. Conversions ! Redesignation of accounts: conversions and recharacterizations made with the same trustee may be accomplished by redesignating the account or annuity contract. Therefore, trustees and custodians are not required to open a new account or issue a new annuity contract for each conversion or recharacterization. ! Change in filing status and the 4-year spread: a change in filing status or a divorce does not affect the application of the 4-year spread for 1998 conversions. Therefore, if a married Roth IRA owner who is using the 4-year spread files separately or divorces before the full taxable conversion amount has been included in gross income, the remainder must be included in the Roth IRA owner's gross income over the remaining years in the 4-year period, or, if applicable, in the year for which the remainder is accelerated due to distribution or death. ! Surviving spouse and the 4-year spread: the surviving spouse must be the sole beneficiary of all of a Roth IRA

owner's Roth IRAs to elect to continue the 4-year spread at the Roth IRA owner's death. The IRS states that because section 408A(d)(3)(E)(ii)(II) provides that the surviving spouse must acquire the "entire interest" in any Roth IRA to which a conversion contribution to which the 4-year spread applies is "properly allocable." Because the aggregation rules treat all of a Roth IRA owner's Roth IRAs as a single Roth IRA, a conversion contribution is allocable to all of the owner's Roth IRAs. Therefore, according to the final regulations, a surviving spouse must be the sole beneficiary of all a Roth IRA owner's Roth IRAs in order to acquire the entire interest in any Roth IRA to which a 1998 conversion contribution is properly allocable. ! Substantially equal periodic payments: Roth IRA distributions that are part of a series of substantially equal periodic payments begun under a traditional IRA prior to conversion to a Roth IRA are subject to income acceleration during the 4- year spread to the extent allocable to a 1998 conversion. However, such payments are not subject to the additional 10% penalty under section 72(t), even if they are not qualified distributions. ! Minimum required distributions: the final regulations retain the rule that the required minimum distribution amount is ineligible for rollover, including such a distribution for the year that the individual reaches age 70 1/2 , because under section 408A(d)(3)(C), a conversion is treated as a distribution regardless of whether the conversion is accomplished by a trustee-to-trustee transfer. Therefore, the required minimum distribution is ineligible for rollover and ineligible for conversion to a Roth IRA. Recharacterizations of IRA Contributions 2 See Institute Memorandum to Pension Committee No. 69-98, Pension Operations Advisory Committee No. 52- 98 and Transfer Agent Advisory Committee No. 67-98, dated October 20, 1998. 3 The final regulations contain the following example: a IRA owner whose taxable year is the calendar year and who converts an amount to a Roth IRA in 2000 and then transfers that amount back to a traditional IRA on January 18, 2001 because his or her AGI for 2000 exceeds \$100,000 cannot reconvert that amount until February 17, 2001 (the first day of the 30-day period beginning on the day of the recharacterization transfer) because the failed conversion made in 2000 is treated as a conversion for purposes of the reconversion rules. However, if that IRA owner inadvertently attempts to reconvert that amount before February 17, 2001, the attempted reconversion is not treated as a conversion for purposes of the reconversion rules, although it is otherwise treated as a failed conversion. Therefore, the IRA owner could transfer the amount back to a traditional IRA in a 3 ! Losses: the computation of net income under section 1.408-4(c)(2)(iii) in the case of a commingled IRA may include net losses on the amount to be recharacterized. ! Recharacterizations of SEPs and SIMPLEs: an amount converted from a SEP IRA or SIMPLE IRA to a Roth IRA may be recharacterized back to the SEP IRA or SIMPLE IRA from which the amount was converted. ! Election on behalf of a deceased Roth IRA owner: the election to recharacterize an IRA contribution may be made by the executor, administrator, or other person charged with the duty of filing the decedent's final federal income tax return. ! Recharacterizations of excess contributions: only actual contributions may be recharacterized. Therefore, excess contributions actually made for a prior year and deemed to be current-year contributions for purposes of section 4973 are not contributions eligible for recharacterization, unless the recharacterization would still be timely with respect to the taxable year for which the contributions were actually made. ! Conduit IRAs: a conduit IRA that is converted to a Roth IRA and subsequently recharacterized back to a traditional IRA retains its status as a conduit IRA. ! Withholding: a recharacterization is not subject to withholding pursuant to section 3405, because it is not a designated distribution under this provision of the Code. ! Reconversions: The limitations on reconversions under Notice 98-50 continue to apply to 1998 and 1999 reconversions.² However, effective January 1, 2000, an IRA owner who converts an amount from a traditional IRA to a Roth IRA during any taxable year and then transfers that amount back to a traditional IRA by means of a recharacterization may not

reconvert that amount from the traditional IRA to a Roth IRA before the beginning of the taxable year following the taxable year in which the amount was converted to a Roth IRA, 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 the traditional IRA by means of a recharacterization. A reconversion made before the later of the beginning of the next taxable year or the end of the 30-day period that begins on the day of the recharacterization is treated as a "failed conversion" subject to correction through a recharacterization back to a traditional IRA. Only a failed conversion resulting from a failure to satisfy the statutory requirements for a conversion (e.g., the \$100,000 modified adjusted gross income limit) is treated as a conversion in determining when an IRA owner may make a reconversion.³ recharacterization and reconvert it at any time on or after February 17, 2001. If the IRA owner does not reconvert the amount on or after February 17, 2001, he or she cannot reconvert that amount again until 2002. ⁴ Distributions ! Nonqualified distributions: a nonqualified distribution from a Roth IRA is taxed only to the extent that the amount of the distribution, when added to all previous distributions and reduced by the taxable amount of such previous distributions, exceed the owner's contributions to all of his or her Roth IRAs, i.e., basis is not double-taxed. ! Inherited Roth IRAs: a beneficiary's inherited Roth IRA may not be aggregated with any other Roth IRAs maintained by that beneficiary (except for other Roth IRAs inherited from the same decedent), unless the beneficiary, as the spouse of the decedent and the sole beneficiary of the Roth IRA, elects to treat the Roth IRA as his or her own. ! 5-year aging rule: if the entire account balance in a Roth IRA is distributed to the Roth IRA owner before he or she makes subsequent Roth IRA contributions, the 5- year aging period does not start over with the subsequent contributions. However, if the initial Roth IRA contribution is made to a Roth IRA that is subsequently revoked in 7 days or if the initial Roth IRA contribution is recharacterized, the initial contribution does not start the 5-year period. A copy of the final regulations is attached. Kathryn A. Ricard Assistant Counsel Attachment