

MEMO# 10243

September 1, 1998

INTERNAL REVENUE SERVICE RELEASES ROTH IRA PROPOSED REGULATIONS

[10243] September 1, 1998 TO: PENSION MEMBERS No. 56-98 TRANSFER AGENT ADVISORY COMMITTEE No. 54-98 AD HOC COMMITTEE ON ROTH IRA RE: INTERNAL REVENUE SERVICE RELEASES ROTH IRA PROPOSED REGULATIONS

The Internal Revenue Service has released proposed regulations relating to Roth IRAs. Specifically, the proposed regulations clarify various Roth IRA provisions in the Taxpayer Relief Act of 1997 and the technical corrections provisions legislation. Note that although the guidance is in the form of proposed regulations, taxpayers may rely on these proposed regulations for guidance pending the issuance of final regulations. If the final regulations are more restrictive than the proposed regulations, then the final guidance will be applied on a prospective basis. In addition, the proposed regulations state that the Service will be issuing additional guidance in the form of a notice in the near future regarding reporting requirements applicable to the Roth IRA. The proposed regulations are in a question and answer format and discuss the following issues: (1) Roth IRAs in general; (2) Establishing a Roth IRA; (3) Contributions to a Roth IRA; (4) Converting amounts to a Roth IRA; (5) Recharacterized contributions; (6) Distributions; (7) Reporting; (8) Definitions; (9) Effective Date. Highlights of the proposed regulations are as follows: ` A Roth IRA is treated for federal tax purposes in the same manner as an individual retirement plan except as otherwise provided in section 408A and the proposed regulations. Thus, the rules of section 408 of the Code and the regulations under section 408 apply to Roth IRAs to the extent that they are not inconsistent with section 408A or the proposed regulations. ` Amounts held in a SEP or SIMPLE IRA may be converted to a Roth IRA. In the case of a SIMPLE IRA, the conversion may be made only after the expiration of the 2-year period applicable to SIMPLE plans, as described in section 72(t)(6). However, once a SEP or SIMPLE IRA is converted to a Roth IRA, it becomes a Roth IRA and no SEP or SIMPLE IRA contributions may be made to a Roth IRA. ` For conversions of traditional IRAs to a Roth IRAs executed by means of a rollover, i.e., a distribution and rollover contribution, the year of the distribution from the traditional IRA is the year in which the conversion amount is includible in gross income. ` A required minimum distribution may not be converted to a Roth IRA. However, in years beginning after December 31, 2004, solely for purposes of the \$100,000 AGI conversion limitation, modified AGI does not include any minimum required distributions from an IRA. ` A taxpayer may elect not to have the 4-year spread applicable to 1998 Roth IRA conversions apply. A taxpayer makes such an election on Form 8606. Such election cannot be made or changed after the due date (including extensions) for filing the 1998 federal income tax return. ` A "recharacterization" transfer, i.e., error correction transaction, is not considered a rollover for purposes of the one-rollover-per-year rules of section 408(d)(3). The proposed regulations interpret the recharacterization provision of the technical

corrections legislation liberally to provide broad relief to taxpayers who wish to change the nature of an IRA contribution and not only to allow taxpayers to correct Roth IRA conversions for which they were ineligible. The taxpayer makes the election to recharacterize an IRA contribution by notifying both the transferor IRA trustee and the transferee IRA trustee by providing certain information to these trustees, including a direction to make the transfer. The taxpayer cannot revoke or modify the election after the recharacterization transfer has been made. The recharacterization transfer must include any applicable earnings or losses as of the time of recharacterization. ` Employer contributions under a SIMPLE IRA or a SEP IRA cannot be recharacterized as contributions to another IRA. ` A conversion that is accomplished through a rollover of a distribution from a traditional IRA in a taxable year that, within 60 days after the distribution, is contributed to a Roth IRA in the next taxable year, is treated as a contribution for the earlier taxable year. ` The 5-taxable-year period for determining whether a distribution is a qualified distribution is not recalculated when a Roth IRA owner dies. However, if a surviving spouse treats the Roth IRA as his or her own, the 5-taxable-year period with respect to any of the surviving spouse's Roth IRAs (including the one that the surviving spouse treats as his or her own) ends at the earlier of the 5-taxable-year period for the decedent or the 5-taxable-year period applicable to the spouse's own Roth IRAs. ` Roth IRA distributions are treated as if made first from Roth IRA contributions and second from earnings. Distributions that are treated as made from contributions are treated as made first from regular contributions and then from conversion contributions on a first-in, first-out basis. Aggregation rules are as follows: all distributions from all of a taxpayer's Roth IRAs made during a taxable year are aggregated; all regular contributions made for the same taxable year to all the individual's Roth IRAs are aggregated and added to the undistributed total regular contributions for prior taxable years; all conversion contributions received during the same taxable year by all the individual's Roth IRAs are aggregated; and rollovers between Roth IRAs are disregarded. ` Upon the death of a Roth IRA owner, the rules in Proposed Treasury Regulation section 1.408-8 apply as though the Roth IRA owner died before his or her required beginning date. Thus, the entire amount of the Roth IRA must generally be distributed within five years of the Roth IRA owner's death unless it is distributed over the life expectancy of a designated beneficiary beginning prior to the end of the calendar year following the year of the owner's death. If the beneficiary is the Roth IRA owner's surviving spouse, the spouse may delay distributions until the Roth IRA owner would have reached age 70 1/2 or may treat the Roth IRA as his or her own. ` The section 3405 withholding rules applies to distributions from Roth IRAs and Roth IRA conversions. ` No amount may be transferred directly from an Education IRA to a Roth IRA. ` The reporting requirements applicable to traditional IRAs apply to Roth IRAs except that a trustee of a Roth IRA must include additional information on Forms 1099-R and 5498 as described in the instructions. Taxpayers who convert a traditional IRA to a Roth IRA must report the conversion by filing a Form 8606. Trustees may rely on the reasonable representations of a Roth IRA contributor or distributee for purposes of fulfilling reporting obligations. Written comments on the proposed regulations must be received by the Service by December 2, 1998. A public hearing on the Roth IRA proposed regulations is scheduled for December 10, 1998. A copy of the proposed regulations is attached. Kathryn A. Ricard Assistant Counsel Attachment