

MEMO# 10429

October 28, 1998

CALIFORNIA ISSUES LEGAL RULING ON ROTH IRA RECHARACTERIZATIONS

1 See Institute Memorandum to Pension Members No. 62-98, Pension Operations Advisory Committee No. 51- 98 and Transfer Agent Advisory Committee No. 65-98, dated October 16, 1998. [10429] October 28, 1998 TO: PENSION MEMBERS No. 65-98 PENSION OPERATIONS ADVISORY COMMITTEE No. 56-98 TRANSFER AGENT ADVISORY COMMITTEE No. 72-98 RE: CALIFORNIA ISSUES LEGAL RULING ON ROTH IRA RECHARACTERIZATIONS

The California Franchise Tax Board (the "FTB") recently released Legal Ruling 98-4, which provides guidance concerning California's tax treatment of recharacterizations of Roth IRA contributions. As you were previously informed a recent memorandum¹, the governor of California recently vetoed legislation that would have conformed California's income tax treatment of the Roth IRA to the technical corrections provisions contained in the Internal Revenue Service Restructuring and Reform Act of 1998. Legal Ruling 98-4 states that section 408A(b) of the Internal Revenue Code, as applicable for California purposes, authorizes the FTB to prescribe the manner for designating an individual retirement plan as a Roth IRA. Pursuant to this authority, FTB Legal Ruling 98-4 states that with regard to the 1998 taxable year, if a taxpayer makes a trustee-to-trustee transfer from a Roth IRA to a traditional IRA that results in a recharacterization of contribution to the Roth IRA, such trustee-to-trustee transfer will be treated, for California purposes, as revoking the designation of the individual retirement plan from which such amounts were transferred as a Roth IRA. The revocation is not applicable for purposes of applying the one-year rule on rollover contributions to an IRA. However, the Legal Ruling notes that California taxpayers may not elect out of the 4-year spread for 1998 Roth IRA conversions. In addition, the Legal Ruling provides two examples of recharacterization scenarios -- example #1 involves a recharacterization as a result of ineligibility, i.e., AGI in excess of \$100,000, and example #2 involves a recharacterization as a result of a market drop. In both examples #1 and #2, the taxpayer is treated, for California purposes, as having made an eligible rollover contribution from traditional IRA #1 to another traditional IRA, IRA #2, and a trustee-to-trustee transfer from traditional IRA #2 to traditional IRA #3. Further, in both examples, the taxpayer would not include either the rollover contribution or the trustee-to-trustee transfer in gross income. In example #2, the taxpayer would be eligible to make another qualified rollover contribution from traditional IRA #3 to a Roth IRA and, similar to federal tax treatment, the amount includible in income would be based on the value of traditional IRA #3 at the time of the conversion, i.e., the lower value resulting from the market drop. - 2 - In addition, the FTB released Legal Ruling 98-3, which analyzes the taxation of IRA distributions rolled over to a Roth IRA followed by a change of residence status. Copies of Legal Rulings 98-3 and 98-4 are attached. Kathryn A. Ricard Assistant Counsel Attachment Note: Not all recipients of this memo will receive an attachment. If you wish to obtain a

copy of the attachment referred to in this memo, please call the Institute's Library Services Division at (202)326- 8304, and ask for this memo's attachment number: 10429.

Copyright © by the Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice.