

**MEMO# 10081**

June 29, 1998

## **HOUSE PASSES TECHNICAL CORRECTIONS LEGISLATION**

[10081] June 29, 1998 TO: PENSION MEMBERS No. 38-98 PENSION OPERATIONS ADVISORY COMMITTEE No. 24-98 TRANSFER AGENT ADVISORY COMMITTEE No. 34-98 AD HOC COMMITTEE ON ROTH IRA AD HOC COMMITTEE ON EDUCATION IRA RE: HOUSE PASSES TECHNICAL CORRECTIONS LEGISLATION

Before adjourning for the July 4th recess, the House passed the Internal Revenue Service Restructuring and Reform Act of 1998, H.R. 2676. Included in this legislation, are the technical correction provisions that clarify certain Roth IRA and Education IRA provisions of the Taxpayer Relief Act of 1997. Some time after returning from the July 4th recess the week of July 6, the Senate is expected to vote on this bill. The President has indicated that he will sign this legislation into law. The technical corrections provisions clarify certain Roth IRA, Education IRA and miscellaneous IRA and qualified plan issues as follows: 1. ROTH IRAS With regard to the Roth IRA, the bill clarifies the following: 1. Aging. The five-year aging period will begin with the first taxable year in which an individual made a contribution to a Roth IRA, including a rollover contribution. A separate 5-year aging rule will not be applied to Conversion Roth IRAs for purposes of identifying qualified distributions. 2. Conversions. a. The 4-year spread on income inclusion applicable to 1998 Roth IRA conversions is elective. Therefore, taxpayers may elect to have the amount converted in 1998 included in income in 1998, rather than ratably over 4 years. b. Distributions from 1998 Roth IRA conversions during the first three years to which the 4- year income inclusion applies (assuming the 4-year spread was elected) are subject to an accelerated income inclusion rule as follows: the taxpayer making such a withdrawal will include in income amounts otherwise includible under the 4-year income inclusion rule and the lesser of (1) the taxable amount of the withdrawal or (2) the remaining taxable amount of the conversion. In subsequent years, to the extent there are no additional withdrawals, the amount includible in income under the 4-year spread is the lesser of (1) the amount otherwise required under the 4-year income inclusion rule determined without regard to the withdrawal or (2) the remaining taxable amount of the conversion. c. If a taxpayer dies during the 4-year income inclusion period applicable to 1998 conversions, the remaining amounts of income are required to be included on the final tax return of the taxpayer. However, if the surviving spouse is the beneficiary, he or she may elect to include the remaining amounts in income over the remainder of the 4-year period. d. Distributions from Conversion Roth IRAs during the 5-year period following the conversion are subject to the section 72 penalty on early withdrawals. Specifically, the amount of the premature distribution, to the extent attributable to amounts includible in income due to the conversion, is subject to the section 72 penalty, unless an exception to section 72 applies. 3. Aggregation and Ordering Rules. The aggregation rules of section 408(d)(2) are applied separately to Roth IRAs and

traditional IRAs. The ordering rules for distributions from Roth IRAs are as follows: (1) contributions from contributory Roth IRAs; (2) contributions to a Conversion Roth IRA on a first-in- first-out basis. Distributions allocated to a Conversion Roth IRA are allocated first to the portion of the contribution that was included in gross income at the time of the conversion. 4. Error Correction. Individuals who erroneously converted a traditional IRA into a Roth IRA, or who otherwise wish to change the nature of an IRA contribution, may transfer amounts and earnings from any IRA to any other IRA prior to the due date of the taxpayer's return, including extensions. This transfer must be via a trustee-to-trustee transfer. 5. Designation of Roth IRAs. A SEP or SIMPLE IRA may not be designated as a Roth IRA. Therefore, contributions to a SEP or SIMPLE IRA may not be commingled with Roth IRA contributions. In addition, contributions to SEP and SIMPLE IRAs are not taken into account for purposes of the \$2,000 contribution limit to traditional or Roth IRAs. Note that neither the bill nor the accompanying report addresses whether taxpayers may convert a SEP IRA or a SIMPLE IRA directly to a Roth IRA. It is anticipated that Treasury will issue guidance on this issue. 6. Modification of AGI Limit for Conversions to Roth IRAs. Effective for tax years after December 31, 2004, required minimum distributions are excluded from the definition of AGI solely for purposes of determining eligibility to convert a traditional IRA to a Roth IRA, i.e., the \$100,000 AGI limitation for conversions. 7. AGI Limit for Conversions. For purposes of determining the \$100,000 AGI limit for Roth IRA conversions, the conversion amount is not taken into account. II. EDUCATION IRAS With regard to the Education IRA, the bill clarifies the following: 1. Definitional Clarification. a. The definition of the term, "member of the family," at Code section 529(e)(2), is clarified to include the spouse of a designated beneficiary and the spouse of any person enumerated in the statute. b. Section 530(b)(1) is amended to state that the designated beneficiary must be "an individual." This change is intended to clarify that an Education IRA may not be established for a child not yet born and must be a 'life-in-being.' 2. Rollovers And Account Redesignation To Family Member Under Age 30. The bill clarifies that an Education IRA may be rolled over to (or redesignated for) another beneficiary who is a "member of the family" as long as the new beneficiary is under the age of 30. (It had been unclear whether the statute required the new beneficiary to be under age 18 or under age 30.) 3. Distribution From Education IRA Account At Age 30 or Death. Section 530(b)(1)(e) is amended to require that any balance remaining in an Education IRA be distributed from the account within 30 days after the date upon which the designated beneficiary attains age 30 or if earlier, within 30 days after the date of the beneficiary's death. If such distribution has not occurred at the end of the 30-day period, the account balance will be "deemed distributed." 4. Contingent Beneficiary Exception To Required Distribution At Death. In the event of the death of a designated beneficiary, the balance remaining in an Education IRA may be distributed to any other beneficiary or to the estate of the deceased designated beneficiary. Furthermore, a tax-free rollover or redesignation of the account will be allowed if a "member of the family" (as defined in section 529(e)(2)) becomes the new beneficiary. More specifically, the bill treats family members in the same manner as spouses upon the death of a designated beneficiary, by reference to the Medical Savings Account (MSA) rule at Code section 220(f)(8). 5. Clarification of Tax Treatment of Nonqualified Distributions Under Section 72. The bill clarifies that nonqualified distributions from Education IRAs are treated as representing a pro-rata share of the principal and accumulated earnings in the account. 6. Clarification of Applicability of Excise Taxes to Certain Distributions and Excess Contributions. a. The 10-percent excise tax on nonqualified distributions will not apply to a distribution from an Education IRA that is used to pay qualified higher education expenses and is includible in income solely because the taxpayer elects the HOPE or Lifetime Learning tax credit with respect to the beneficiary. Also, the excise tax will not apply to the distribution of an excess contribution made in any tax year, if the distribution is made on or

before the due date (including extensions of time) of the beneficiary's tax return. If the beneficiary is not required to file a tax return, the distribution must occur before April 15th of the calendar year following the year in which the contribution was made. b. The 6-percent excise tax on excess contributions to an Education IRA applies in each year that an excess contribution remains in an Education IRA, not only in the first year the excess occurs. 7. Coordination With Sections 135 and 162. To the extent that qualified higher education expenses are taken into account when determining the exclusion under section 530, such excluded amounts may not be taken into account for purposes of a tax credit, deduction or exclusion under Code sections 135 or 162. III. MISCELLANEOUS The bill also clarifies various miscellaneous IRA and qualified plan issues as follows: 1. Spousal Delinking. A taxpayer, whose spouse is an active participant in a pension plan, may make a deductible IRA contribution of up to \$2,000, assuming joint AGI does not exceed \$150,000. The amount of the allowable deductible contribution phases out over AGI of \$150,000 to \$160,000. 2. Deferred Compensation. Deferred employee compensation is considered paid, for purposes of section 404, when it is actually received by the employee. 3. Hardship Distributions. Hardship distributions from 401(k) plans or other similar arrangements are not eligible rollover distributions and are not subject to the 20 percent withholding rule applicable to such rollovers. Therefore, taxpayers may not rollover such hardship distributions to IRAs. This proposal is effective for distributions after December 31, 1998. Copies of the relevant portions of the bill and accompanying report are attached. Russell G. Galer Senior Counsel Kathryn A. Ricard Assistant Counsel Attachments