

MEMO# 9806

March 30, 1998

SENATE FINANCE COMMITTEE CONSIDERS ROTH AND EDUCATION IRA TECHNICAL CORRECTIONS

1 See Institute Memorandum to Pension Committee No. 40-97 and Pension Operations Advisory Committee No. 39-97, dated October 10, 1997. [9806] March 30, 1998 TO: PENSION COMMITTEE No. 18-98 PENSION OPERATIONS ADVISORY COMMITTEE No. 12-98 AD HOC ROTH IRA COMMITTEE AD HOC EDUCATION IRA COMMITTEE RE: SENATE FINANCE COMMITTEE CONSIDERS ROTH AND EDUCATION IRA TECHNICAL CORRECTIONS

The Senate Finance Committee is actively considering legislation to make technical corrections to the previously enacted Taxpayer Relief Act of 1997. Attached are relevant portions of the Chairman's "mark," which will serve as a basis for Committee discussion. The proposal would change both the Roth IRA and Education IRA provisions. With regard to the Roth IRA, it differs significantly from the House technical corrections bill passed last fall, and is generally consistent with positions the Institute has advocated.¹ It is anticipated that the Senate Finance Committee will consider and likely vote on these technical corrections prior to recess planned for April 10.

I. Roth IRAs The proposal would clarify the following:

A. Conversions (1) Application of the 4-year spread on income inclusion resulting from a conversion would be elective; (2) In the case of conversions to which the 4-year income inclusion rule applies, income inclusion would be accelerated with respect to amounts withdrawn before the final year of inclusion; the taxpayer making such a withdrawal would include in income the amounts otherwise includible under the 4-year rule and also would include 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 would be the lesser of (1) the amount otherwise required under the 4-year rule determined without regard to the withdrawal or (2) the remaining taxable amount of the conversion (N.B., an example in the text of the proposal clarifies the mechanics of this rule); - 2 - (3) There would be no separate 5-year aging rule applied to conversion amounts for purpose of identifying qualified distributions; (4) If converted amounts, however, are withdrawn within the five-year period beginning with the year of conversion, then, to the extent attributable to amounts that were includible in income due to conversion, the amount withdrawn would be subject to an additional 10 percent penalty, unless an exception to the early withdrawal tax applied; (5) Ordering rules for withdrawals would deem regular Roth contributions to be withdrawn first from an account and then converted amounts, with converted amount withdrawals coming first from the amounts first converted; for purposes of applying the ordering rules, a taxpayer would aggregate all accounts; (6) Unlike the House technicals bill, there would be no requirement to establish separate accounts for conversion amounts.

B. Error Correction Individuals who erroneously convert IRAs to Roth IRAs or otherwise wish to change the nature of an IRA contribution may transfer amounts and earnings thereon from any IRA to another prior to the due date of the taxpayer's return.

C. Effect of Death on 4-year Spread Any amounts remaining to be included in income as the result of a 1998 conversion would be includible in income on the final return of the taxpayer. However, if the surviving spouse is the beneficiary of the Roth IRA, the spouse would "step into the shoes" of the taxpayer and include remaining amounts in income over the remainder of the 4-year period.

D. \$100,000 AGI Clarification The proposal would clarify that the conversion amount is not included in AGI when determining whether a taxpayer is eligible to convert an IRA into a Roth IRA.

II. Education IRA The proposal would clarify the following: (1) Any balance remaining in an Education IRA would be deemed distributed within 30 days after the date the named beneficiary reaches age 30 or, if earlier, within 30 days of the date that the beneficiary dies; (2) The additional 10-percent penalty for non-qualified distributions from an Education IRA would not apply to a distribution which, while used to pay education expenses, is includible in the beneficiary's income solely because the taxpayer elects to claim a HOPE or Lifetime Learning tax credit; (3) The 10-percent penalty tax would not apply to the distribution of a contribution to an Education IRA made during a taxable year if the distribution is made on or before the date that a return is required to be filed (including filing extensions) by the beneficiary for the taxable year during which the contribution was made; - 3 - (4) The 6% excise tax penalty would apply each year that an excess contribution remains in the Education IRA, not only the first year in which the excess contribution was made; (5) Distributions from Education IRAs would be treated as representing a pro-rata share of principal and earnings; and (6) Qualified higher education expenses taken into account when determining the exclusion under section 530 would not be permitted to be taken into account for a section 162 deduction or section 135 exclusion.

III. Penalty-free IRA Distributions and Hardship Distributions From Qualified Plans The proposal would provide that distributions from 401(k) plans or other similar arrangements made on account of hardship are not "eligible rollover distributions" and not subject to the 20- percent withholding rule applicable to such rollovers. Because they would not be not eligible rollover distributions, they would not be able to be rolled over into an IRA and distributed under the IRA's penalty-free, early withdrawal rules. This proposal would effective for distributions after December 31, 1998.

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Attachment