

[4830-01-u]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[TD 8816]

RIN 1545-AW62

Roth IRAs

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations

SUMMARY: This document contains final regulations relating to Roth IRAs under section 408A of the Internal Revenue Code (Code). Roth IRAs were created by the Taxpayer Relief Act of 1997 as a new type of IRA that individuals can use beginning in 1998. Section 408A was amended by the Internal Revenue Service Restructuring and Reform Act of 1998. On September 3, 1998, a notice of proposed rulemaking was published in the **Federal Register** (63 FR 46937) under Code section 408A. Written comments were received regarding the proposed regulations. On December 10, 1998, a public hearing was held on the proposed regulations. The final regulations affect individuals establishing Roth IRAs, beneficiaries under Roth IRAs, and trustees, custodians or issuers of Roth IRAs.

DATES: Effective date: The final regulations are effective on February 3, 1999.

Applicability date: The final regulations are applicable to taxable years beginning on or after January 1, 1998, the effective date for section 408A.

FOR FURTHER INFORMATION CONTACT: Cathy A. Vohs, (202) 622-6030 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in §§1.408A-2, 1.408A-4, 1.408A-5, and 1.408A-7 of the final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545-1616. Responses to this collection of information are mandatory.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Estimated average annual burden per respondent/recordkeeper: 1 minute for designating an IRA as a Roth IRA and 30 minutes for recharacterizing an IRA contribution. The estimated burdens for the other reporting/recordkeeping requirements in these final regulations are reflected in the burden of Forms 8606, 1040, 5498, and 1099R.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

On September 3, 1998, a notice of proposed rulemaking was published in the **Federal Register** (63 FR 46937) under section 408A of the Internal Revenue Code (Code). The proposed regulations provide guidance on section 408A of the Code, which was added by section 302 of the Taxpayer Relief Act of 1997, Public Law 105-34 (111 Stat. 788), and established the Roth IRA as a new type of individual retirement plan, effective for taxable years

beginning on or after January 1, 1998. The provisions of section 408A were amended by the Internal Revenue Service Restructuring and Reform Act of 1998, Public Law 105-206 (112 Stat. 685). In addition, Notice 98-50 (1998-44 I.R.B. 10) provides guidance on reconverting an amount that had previously been converted and recharacterized. This notice solicited public comments concerning reconversions.

Written comments were received on the proposed regulations and Notice 98-50. A public hearing was held on the proposed regulations and Notice 98-50 on December 10, 1998. After consideration of all the comments, the proposed regulations under section 408A are adopted as revised by this Treasury decision.

Explanation of Provisions

Overview

A Roth IRA generally is treated under the Code like a traditional IRA with several significant exceptions. Similar to traditional IRAs, income on undistributed amounts accumulated under Roth IRAs is exempt from Federal income tax, and contributions to Roth IRAs are subject to specific limitations. Unlike traditional IRAs, contributions to Roth IRAs cannot be deducted from gross income, but qualified distributions from Roth IRAs are excludable from gross income.

In general, comments received on the proposed regulations did not request significant changes. Thus, the final regulations retain the general structure and substance of the proposed regulations.

General Provisions and Establishment of Roth IRAs

Commentators asked for clarification regarding whether a Roth IRA may be established for the benefit of a minor child or anyone else who lacks the legal capacity to act on his or her own behalf. On this point, the IRS and Treasury intend that the rules for traditional IRAs also apply to Roth IRAs. Thus, for example, a parent or guardian of a minor child may establish a Roth IRA on behalf of the minor child. However, in the case of any contribution to a Roth IRA established for a minor child, the compensation of the child for the taxable year for which the

contribution is made must satisfy the compensation requirements of section 408A(c) and §1.408A-3.

Regular Contributions

Several commentators requested clarification of the treatment of excess Roth IRA contributions under sections 4973, 408(d)(5), and 219(f)(6). Commentators asked for clarification regarding the removal of excess Roth IRA contributions after the contributor's Federal tax return due date has passed. The final regulations clarify that, pursuant to section 4973(f), excess contributions 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. However, in response to several requests for clarification, the IRS and Treasury note that the rules under section 408(d)(5) for the taxfree distribution of certain excess traditional IRA contributions after the IRA owner's Federal income tax return due date do not apply to Roth IRAs because Roth IRA contributions are always taxfree on distribution (except to the extent that they accelerate income inclusion under the 4-year spread). Similarly, 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.

Another commentator asked for clarification whether contributions to education IRAs are disregarded for purposes of applying the limitation on regular contributions to Roth IRAs. No change has been made to the final regulations on this point because the final regulations retain the definition of an IRA provided in the proposed regulations, which excludes an education IRA under section 530. Thus, contributions to an education IRA are disregarded in applying the Roth IRA contribution limitation (and in applying the contribution limitation for traditional IRAs).

Conversions

In response to certain comments, the final regulations clarify that conversions and recharacterizations made with the same trustee may be accomplished by redesignating the

account or annuity contract, rather than by the opening of a new account or the issuance of a new annuity contract for each conversion or recharacterization.

As requested by commentators, the final regulations provide that a change in filing status or a divorce does not affect the application of the 4-year spread for 1998 conversions. Thus, 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.

Two commentators questioned why the proposed regulations require that a surviving spouse be the sole beneficiary of all a Roth IRA owner's Roth IRAs in order to elect to continue application of the 4-year spread after the Roth IRA owner's death. The IRS and Treasury view this result as compelled by the statutory language of section 408A(d)(3)(E)(ii)(II). That section provides that the surviving spouse must acquire the Aentire interest@ in any Roth IRA to which a conversion contribution to which the 4-year spread applies is Aproperly allocable.@ Under the aggregation and ordering rules of section 408A(d)(4), all a Roth IRA owner's Roth IRAs are treated as a single Roth IRA, and a conversion contribution is therefore allocable to all the owner's Roth IRAs. Thus, 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.

Commentators also asked the IRS and Treasury to clarify whether 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 period and the 10-percent additional tax on early distributions under section 72(t). The final regulations clarify that those distributions are subject to income acceleration to the extent allocable to a 1998 conversion contribution with respect to which the 4-year spread applies. The

final regulations further clarify, however, that the additional 10-percent tax under section 72(t) will not apply, even if the distributions are not qualified distributions (as long as they are part of a series of substantially equal periodic payments).

Under the proposed regulations, if an IRA owner has reached age 70 ½, any amount distributed (or treated as distributed because of a conversion) from the IRA for a year consists of the required minimum distribution to the extent that an amount equal to the required minimum distribution for that year has not yet been distributed (or treated as distributed); as a required minimum distribution, that amount cannot be converted to a Roth IRA. Although one commentator requested that this rule be retained in the final regulations, other commentators objected to it. A number of commentators asked the IRS and Treasury to adopt a rule allowing an IRA owner who wishes to convert a traditional IRA to a Roth IRA in the year he or she turns 70 ½ to leave the amount of his or her required minimum distribution with respect to such IRA in the IRA until April 1 of the following year, provided the conversion is accomplished by means of a trustee-to-trustee transfer. The commentators note that this rule applies in the case of trustee-to-trustee transfers between traditional IRAs. 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 ½, because, pursuant to 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. Accordingly, the required minimum distribution amount is ineligible for rollover, and as such, is also ineligible to be converted to a Roth IRA.

Additionally, several commentators suggested that the rule in the proposed regulations is inconsistent with section 401(a)(9), which generally requires that IRA distributions begin by April 1 of the calendar year following the calendar year in which the IRA owner reaches age 70 ½. These commentators argued that, under section 401(a)(9), distributions made during the calendar year in which the IRA owner reaches age 70 ½ should not be considered required minimum distributions under sections 401(a)(9) and 408(a)(6) and (b)(3). However, the

proposed regulations under sections 401(a)(9) and 408(a)(6) and (b)(3) provide that the first year for which distributions are required under section 401(a)(9) is the year in which the IRA owner reaches age 70 ½, and that distributions made prior to April 1 of the following calendar year are treated as made for that first year. The regulations under section 402(c) and the proposed regulations under sections 401(a)(9) and 408(a)(6) and (b)(3) provide that the first amount distributed during a calendar year is treated as a required minimum distribution to the extent that the amount required to be distributed for that calendar year under section 401(a)(9) has not been distributed. For these reasons, the final regulations retain the rule of the proposed regulations.

Recharacterizations of IRA Contributions

The final regulations clarify that the computation of net income under §1.408-4(c)(2)(iii) in the case of a commingled IRA may include net losses on the amount to be recharacterized.

Commentators asked the IRS and Treasury to clarify whether 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. The final regulations provide that Roth IRA conversion contributions from a SEP IRA or SIMPLE IRA may be recharacterized to a SEP IRA or SIMPLE IRA (including the original SEP IRA or SIMPLE IRA). Another commentator also asked for clarification whether it is necessary to track the source of assets (i.e., as employer or employee contributions) converted from a SEP IRA or SIMPLE IRA to a Roth IRA for purposes of determining whether such assets may be recharacterized. The prohibition on recharacterizing employer contributions to a SEP IRA or SIMPLE IRA set forth in the final regulations only applies to those contributions at the time they are made to the SEP IRA or SIMPLE IRA. Once such contributions have been made to a SEP IRA or a SIMPLE IRA, the SEP IRA or SIMPLE IRA may be converted to a Roth IRA and subsequently recharacterized (provided, in the case of a SIMPLE IRA, that the two-year rule has been satisfied prior to the conversion).

Commentators asked for clarification regarding whether an election to recharacterize an IRA contribution may be made on behalf of a deceased IRA owner. The final regulations provide that 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.

Commentators also asked whether an excess contribution to an IRA made in a prior year, and applied against the contribution limits in the current year under section 4973, may be recharacterized. Only actual contributions may be recharacterized; thus, excess contributions actually made for a prior year and deemed to be current-year contributions for purposes of section 4973, are not contributions that are eligible to be recharacterized (unless the recharacterization would still be timely with respect to the taxable year for which the contributions were actually made). This rule applies to any excess contribution, whether made to a traditional or a Roth IRA.

Commentators asked for clarification regarding a conduit IRA that is converted to a Roth IRA and subsequently recharacterized back to a traditional IRA. The IRS and Treasury note that 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 because the effect of the recharacterization is to treat the amount recharacterized as though it had been transferred directly from the original conduit IRA into another conduit IRA.

Commentators also asked whether a recharacterization is subject to withholding. A recharacterization is not a designated distribution under section 3405 and, therefore, is not subject to withholding.

The final regulations also provide rules regarding the Areconversion@ of an amount that has been transferred from a Roth IRA to a traditional IRA by means of a recharacterization afterhaving been earlier converted from a traditional IRA to a Roth IRA. After publication of the proposed regulations, the IRS and Treasury issued Notice 98-50, which provides interim rules

regarding Roth IRA reconversions made during 1998 and 1999. Notice 98-50 stated that the interim rules were intended to clarify and supplement the proposed regulations and permitted taxpayers to rely on those rules as if incorporated in the proposed regulations. Notice 98-50 noted that the IRS and Treasury were considering whether the final regulations should provide that a taxpayer is not eligible to reconvert an amount before the end of the taxable year in which the amount was first converted (or the due date for that taxable year), or that a taxpayer who transfers a converted amount back to a traditional IRA in a recharacterization must wait until the passage of a fixed number of days before reconverting. Although Notice 98-50 invited interested parties to submit comments on those approaches, little comment was received on that issue. The final regulations provide reconversion rules for 2000 and subsequent years that generally differ from the interim rules of Notice 98-50. However, for 1998 and 1999, the final regulations continue the interim rules of Notice 98-50.

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 a traditional IRA by means of a recharacterization. As under Notice 98-50, any amount previously converted is adjusted for subsequent net income in determining the amount subject to the limitation on subsequent reconversions.

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" (a distribution from the traditional IRA and a regular contribution to the Roth IRA), subject to correction through a recharacterization back to a traditional IRA. For these purposes, 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. Thus, an 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 adjusted gross income for 2000 exceeds \$100,000 cannot reconvert that amount until February 17, 2001 (the first day after the end 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 recharacterization and reconvert it at any time on or after February 17, 2001. If the IRA owner does reconvert the amount on or after February 17, 2001, he or she cannot reconvert that amount again until 2002.

As indicated above, the final regulations continue the interim rules of Notice 98-50 applicable for 1998 and 1999. Therefore, an IRA owner who converts an amount from a traditional IRA to a Roth IRA during 1998 and then transfers that amount back to a traditional IRA by means of a recharacterization may reconvert that amount once (but no more than once) on or after November 1, 1998 and on or before December 31, 1998; the IRA owner may also reconvert that amount once (but no more than once) during 1999. Similarly, an IRA owner who converts an amount from a traditional IRA to a Roth IRA during 1999 that has not been converted before and then transfers that amount back to a traditional IRA by means of a recharacterization may reconvert that amount once (but no more than once) on or before December 31, 1999. In contrast to the rule for years after 1999, a failed conversion is not treated as a conversion for these 1998 and 1999 interim rules.

As did Notice 98-50, the final regulations provide that a reconversion made during 1998 or 1999 for which the IRA owner was not eligible is deemed to be an Aexcess reconversion@ and does not change the IRA owner's taxable conversion amount. Instead, the excess reconversion and the last preceding recharacterizations are not taken into account for purposes of determining the IRA owner's taxable conversion amount, and the IRA owner's taxable conversion amount is based on the last reconversion that was not an excess reconversion. An excess reconversion is otherwise treated as a valid reconversion. The final regulations grandfather conversions and reconversions made before November 1, 1998.

Distributions

In response to concerns raised in the comments regarding potential double taxation, the final regulations clarify that 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 (whether or not they were qualified distributions) and reduced by the taxable amount of such previous distributions, exceed the owner's contributions to all his or her Roth IRAs.

Commentators also asked for clarification regarding whether a beneficiary may aggregate his or her inherited Roth IRAs with other Roth IRAs maintained by such beneficiary. The final regulations provide that a beneficiary's inherited Roth IRA may not be aggregated with any other Roth IRA maintained by such beneficiary (except for other Roth IRAs that the beneficiary inherited from the same decedent), unless the beneficiary, as the spouse of the decedent and sole beneficiary of the Roth IRA, elects to treat the Roth IRA as his or her own.

In addition, commentators also asked for clarification regarding whether the 5-taxable year period for determining whether a distribution is a qualified distribution starts over for subsequent Roth IRA contributions if the entire account balance in a Roth IRA is distributed to the Roth IRA owner before he or she makes any other Roth IRA contributions. In such a case, the 5-taxable-year period does not start over. However, if an initial Roth IRA contribution is made to a Roth IRA that subsequently is revoked within 7 days, or if an initial Roth IRA

contribution is recharacterized, the initial contribution does not start the 5-year period. The final regulations provide that an excess contribution that is distributed in accordance with section 408(d)(4) does not start the 5-year period.

One commentator questioned the rule in the proposed regulations providing that a distribution allocable to a conversion contribution is treated as made first from the portion (if any) that was includible in gross income as a result of the conversion. The IRS and Treasury note that this result is plainly compelled by section 408A(d)(4)(B)(ii). Another commentator inquired about the treatment of all conversions as designated distributions under section 3405; the commentator suggested that conversions effected by means of trustee-to-trustee transfers should not be treated as designated distributions subject to withholding. However, section 408A(d)(3) treats all Roth IRA conversions as distributions regardless of how they are effected.

Reporting Requirements

The final regulations retain the reporting rules set forth in the proposed regulations.

Effective Date

The final regulations are applicable to taxable years beginning on or after January 1, 1998, the effective date for section 408A.

Special Analyses

It has been determined that the final regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. Further, it is hereby certified, pursuant to sections 603(a) and 605(b) of the Regulatory Flexibility Act, that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. The cost of the collection of information is insignificant because the primary reporting burden is on the individual and not the small entity. Therefore the collection of information will not have a

substantial economic impact. Therefore, a regulatory flexibility analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of the final regulations is Cathy A. Vohs, Office of Associate Chief Counsel (Employee Benefits and Exempt Organizations). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

§1.408A-1 also issued under 26 U.S.C. 408A.

§1.408A-2 also issued under 26 U.S.C. 408A.

§1.408A-3 also issued under 26 U.S.C. 408A.

§1.408A-4 also issued under 26 U.S.C. 408A.

§1.408A-5 also issued under 26 U.S.C. 408A.

§1.408A-6 also issued under 26 U.S.C. 408A.

§1.408A-7 also issued under 26 U.S.C. 408A.

§1.408A-8 also issued under 26 U.S.C. 408A.

§1.408A-9 also issued under 26 U.S.C. 408A. * * *