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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9418]

RIN 1545-BE65

Converting an IRA Annuity to a Roth IRA

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final Regulations.

SUMMARY: This document contains final regulations under section 408A of the Internal Revenue Code (Code). These final regulations provide guidance concerning the tax consequences of converting a non-Roth IRA annuity to a Roth IRA. These final regulations affect individuals establishing Roth IRAs, beneficiaries under Roth IRAs, and trustees, custodians and issuers of Roth IRAs.

DATES: Effective date: These final regulations are effective July 29, 2008.

Applicability date: These regulations are applicable to any Roth IRA conversion where an annuity contract is distributed or treated as distributed from a traditional IRA on or after August 19, 2005.

FOR FURTHER INFORMATION CONTACT: William D. Gibbs at 202-622-6060 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

Roth IRAs and Conversions

This document contains final regulations that amend the Income Tax Regulations (26 CFR Part 1) under section 408A of the Code relating to Roth IRAs. 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), establishes the Roth IRA as a type of individual retirement plan, effective for taxable years beginning on or after January 1, 1998.

The identifying characteristic of Roth IRAs is that all contributions to Roth IRAs are after-tax contributions (that is, an IRA owner cannot take a deduction for a contribution made to a Roth IRA) but qualified distributions are tax-free. A qualified distribution from a Roth IRA is a distribution that is made: (1) at least 5 years after the account owner (or the account owner's spouse) made a Roth IRA contribution, and (2) after age 59 ½, after death, on account of disability, or for a first-time home purchase.

A taxpayer whose modified adjusted gross income for a year does not exceed $100,000 (and who, if married, files jointly)[1] may convert an amount held in a non-Roth IRA (that is, a traditional IRA or SIMPLE IRA) to an amount held in a Roth IRA. If a taxpayer converts an amount held in a non-Roth IRA to a Roth IRA, the taxpayer must include the value of the non-Roth IRA being converted in gross income (to the extent the conversion is not a conversion of basis in the non-Roth IRA).

A conversion may be accomplished by means of a rollover, trustee-to- trustee transfer, or account redesignation. Regardless of the means used to convert, any amount converted from a non-Roth IRA to a Roth IRA is treated as distributed from the non-Roth IRA and rolled over to the Roth IRA. In the case of a conversion involving property, the conversion amount generally is the fair market value of the property on the

[1] These limitations are removed for taxable years beginning after December 31, 2009.

date of distribution or the date the property is treated as distributed from the traditional IRA.

Final regulations regarding Roth IRAs were published in the **Federal Register** on February 4, 1999 (64 FR 5597). On August 19, 2005, the IRS issued temporary regulations under section 408A (70 FR 48868) relating to conversions involving annuities. These temporary regulations were also issued in identical form as proposed regulations (70 FR 48924).

Rev. Proc. 2006-13 (2006-1 CB 315), which was issued on January 17, 2006, in response to several comments received on the temporary and proposed regulations, provided interim guidance with respect to the temporary regulations. See §601.601(d)(2)(ii)(b). After consideration of all comments received on the proposed regulations, these final regulations adopt the provisions of the proposed regulations with certain modifications described in the Explanation of Provisions.

Explanation of Provisions

Like the proposed regulations, these final regulations clarify that when a non-Roth individual retirement annuity is converted to a Roth IRA, the amount that is treated as distributed is the fair market value of the annuity contract on the date the annuity contract is converted. Similarly, when a non-Roth individual retirement account holds an annuity contract as an account asset and the account is converted to a Roth IRA, the amount that is treated as distributed with respect to the annuity contract is the fair market value of the annuity contract on the date the annuity contract is converted (that is distributed or treated as distributed from the non-Roth IRA).

One commentator suggested that the final regulations should clarify that where a conversion is made by surrendering an annuity without retaining or transferring rights, the amount converted, and hence the amount that must be included in income as a result of the conversion, is limited to the surrendered cash value (the actual proceeds to be deposited into the Roth IRA). Rev. Proc. 2006-13 provided that, in such a case, the valuation methods in the temporary regulations do not apply.

The final regulations adopt this suggestion. Thus, to the extent an individual retirement annuity or an annuity contract held by an individual retirement account is surrendered with no retained or transferred rights, the amount treated as a distribution is limited to the surrendered cash value (the actual proceeds available to be deposited into the Roth IRA).

The proposed regulations used a methodology from the gift tax regulations (§25.2512-6) to determine fair market value of an annuity contract. Those rules depend on how soon after purchase the contract was converted and whether future premiums were to be paid. The different time periods were ”soon after” the contract was sold and after the contract ”has been in force for some time.” A commentator stated that these terms are not defined and do not lend themselves to clear or uniform interpretation.

In response to these comments, the final regulations modify the application of the valuation rules taken from the gift tax regulations (collectively referred to under these regulations as the gift tax method). The applicability of one valuation rule within the gift tax method is based upon whether the company which sold the initial contract sells comparable annuities. If there is such a comparable contract currently being sold, the fair market value of the contract is determined as the price of the comparable contract.

For example, assume a taxpayer who is age 60 at the time of the conversion had purchased from an insurance company a contract at an earlier age which will pay him $500 per month for life beginning at age 70. If the insurance company is selling contracts that will provide a taxpayer who is age 60 $500 per month for life at age 70, then the fair market value of the taxpayer's contract, for purposes of determining the amount converted, is the current price of the similar contract. (If the conversion occurs soon after the annuity was sold, the comparable contract is the annuity itself and, thus, the fair market value of the annuity is established by the actual premiums paid for such contract.) This comparable contract valuation rule subsumes the first two methods under the proposed regulations.

The gift tax method under the final regulations includes a second alternative for situations where there is no comparable contract. If no comparable contract is available to make a comparison, the fair market value is established through an approximation that is based on the interpolated terminal reserve at the date of the conversion, plus the proportionate part of the gross premium paid before the date of the conversion which covers the period extending beyond that date. This reserve alternative is the same as the third method under the proposed regulations, except that it applies whenever there is no comparable contract.

Rev. Proc. 2006-13 provided an alternative to the valuation method in the proposed regulations based on the accumulation of premiums and this alternative is included in the final regulations. Under this "accumulation method", the fair market value of an annuity contract is permitted to be determined using the methodology provided in §1.401(a)(9)-6, A-12, with the following modifications. First, all front-end loads and other non-recurring charges assessed in the twelve months immediately preceding the conversion must be added to the account value. Second, future distributions are not to be assumed in the determination of the actuarial present value of additional benefits. Finally, the exclusions provided under §1.401(a)(9)-6, A-12(c)(1) and (c)(2), are not to be taken into account.

These final regulations also provide authority for the Commissioner to issue additional guidance regarding the fair market value of an individual retirement annuity, including formulas to be used for determining fair market value.

Effective Date

These regulations are applicable to any Roth IRA conversion where an annuity contract is distributed or treated as distributed from a traditional IRA on or after August 19, 2005. However, taxpayers may instead apply the valuation methods in the temporary regulations and Rev. Proc. 2006-13 for annuity contracts distributed or treated as distributed from a traditional IRA on or before December 31, 2008. See §601.601 (d)(2)(ii)(b). Thus, for example, the adoption of these final regulations does not eliminate the special rule for 2005 conversions set forth in section 4 of Rev. Proc. 2006-13.

Special Analyses

It has been determined that these 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 final regulations and because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the proposed regulations preceding these final regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal authors of these regulations are William Douglas Gibbs and Cathy V. Pastor of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury Department participated in the development of these regulations.

List of subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for Part 1 continues to read, in part, as follows:

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

Par. 2. Section 1.408A-4T is removed.

§1.408A-4T [Removed].

Par. 3. Section 1.408A-4 is amended by revising Q-14 and A-14 to read as follows:

<u>§1.408A-4 Converting amounts to Roth IRAs</u>.

* * * * *

Q-14. What is the amount that is treated as a distribution, for purposes of determining income inclusion, when a conversion involves an annuity contract?

A-14. (a) In general--(1) Distribution of Fair Market Value Upon Conversion. Notwithstanding §1.408-4(e), when part or all of a traditional IRA that is an individual retirement annuity described in section 408(b) is converted to a Roth IRA, for purposes of determining the amount includible in gross income as a distribution under §1.408A-4, A-7, the amount that is treated as distributed is the fair market value of the annuity contract on the date the annuity contract is converted. Similarly, when a traditional IRA that is an individual retirement account described in section 408(a) holds an annuity contract as an account asset and the traditional IRA is converted to a Roth IRA, for purposes of determining the amount includible in gross income as a distribution under §1.408A-4, A-7, the amount that is treated as distributed with respect to the annuity contract is the fair market value of the annuity contract on the date that the annuity contract is distributed or treated as distributed from the traditional IRA. The rules in this A-14 also apply to conversions from SIMPLE IRAs.

(2) Annuity contract surrendered. Paragraph (a)(1) of this paragraph A-14 does not apply to a conversion of a traditional IRA to the extent the conversion is accomplished by the complete surrender of an annuity contract for its cash value and the reinvestment of the cash proceeds in a Roth IRA, but only if the surrender extinguishes all benefits and other characteristics of the contract. In such a case, the cash from the surrendered contract is the amount reinvested in the Roth IRA.

(3) Definitions. The definitions set forth in §1.408A-8 apply for purposes of this paragraph A-14.

(b) <u>Determination of fair market value</u>--(1) <u>Overview</u>--(i) <u>Use of alternative methods</u>. This paragraph (b) sets forth methods which may be used to determine the fair market value of an individual retirement annuity for purposes of paragraph (a)(1) of this paragraph A-14. However, if, because of the unusual nature of the contract, the value determined under one of these methods does not reflect the full value of the contract, that method may not be used.

(ii) <u>Additional guidance</u>. Additional guidance regarding the fair market value of an individual retirement annuity, including formulas to be used for determining fair market value, may be issued by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(<u>b</u>)).

(2) <u>Gift tax method</u>--(i) <u>Cost of contract or comparable contract.</u> If with respect to an annuity, there is a comparable contract issued by the company which sold the annuity, the fair market value of the annuity may be established by the price of the comparable contract. If the conversion occurs soon after the annuity was sold, the comparable contract may be the annuity itself, and thus, the fair market value of the annuity may be established through the sale of the particular contract by the company (that is, the actual premiums paid for such contract).

(ii) <u>Use of reserves where no comparable contract available</u>. If with respect to an annuity, there is no comparable contract available in order to make the comparison described in paragraph (b)(2)(i) of this paragraph A-14, the fair market value may be established through an approximation that is based on the interpolated terminal reserve at the date of the conversion, plus the proportionate part of the gross premium last paid before the date of the conversion which covers the period extending beyond that date.

(3) Accumulation method. As an alternative to the gift tax method described in paragraph (b)(2) of this paragraph A-14, this paragraph (b)(3) provides a method that may be used for an annuity contract which has not been annuitized. The fair market value of such an annuity contract is permitted to be determined using the methodology provided in §1.401(a)(9)-6, A-12, with the following modifications:

(i) All front-end loads and other non-recurring charges assessed in the twelve months immediately preceding the conversion must be added to the account value.

(ii) Future distributions are not to be assumed in the determination of the actuarial present value of additional benefits.

(iii) The exclusions provided under §1.401(a)(9)-6, A-12(c)(1) and (c)(2), are not to be taken into account.

(c) Effective/applicability date. The provisions of this paragraph A-14 are applicable to any conversion in which an annuity contract is distributed or treated as distributed from a traditional IRA on or after August 19, 2005. However, for annuity contracts distributed or treated as distributed from a traditional IRA on or before December 31, 2008, taxpayers may instead apply the valuation methods in

§1.408A-4T (as it appeared in the April 1, 2008, edition of 26 CFR part 1) and Revenue Procedure 2006-13 (2006-1 CB 315) (See §601.601(d)(2)(ii)(b)).

Linda E. Stiff,
Deputy Commissioner for Services and Enforcement.

Approved: July 20, 2008.

Eric Solomon,
Assistant Secretary of the Treasury (Tax Policy).