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RETIREMENT PLANS

Final Regs Explain How to Convert Traditional IRA to Roth IRA

The IRS has issued final regulations regarding the conversion of annuity contracts from non-Roth IRAs to Roth IRAs under Code Sec. 408A. The final regulations generally track the proposed regulations with changes discussed in detail below.

Background

The Roth IRA is an attractive retirement and estate planning tool that appeals to many taxpayers for several reasons. Unlike a traditional IRA, contributions may be made to a Roth IRA by taxpayers at any age [Code Sec. 408A(c)]. Although taxpayers may not claim a tax deduction for contributions made to the Roth IRA, retirement savings will accumulate tax-free. The deadline for making Roth IRA contributions for 2008 is April 15, 2009, even if the taxpayer has a filing extension. There are no mandatory distributions from Roth IRAs during the owner's lifetime, unlike the traditional IRA which mandates required minimum distributions. The significant differences

between traditional IRAs and Roth IRAs include the following:

- Eligibility to contribute to a Roth IRA is subject to special modified AGI limits.
- Contributions to a Roth IRA are never deductible, whereas contributions to a traditional IRA may be deductible.
- Qualified distributions from a Roth IRA will be tax-free and penalty-free provided the account has been open for at least five years and the taxpayer is over age 59 1/2, or has died, become disabled or is using the withdrawals (up to \$10,000) to purchase a first home.
- Owners of Roth IRAs need not make required minimum distributions which traditional IRA owners must make.
- Contributions may be made to a Roth IRA at any age [Reg. §1.408A-1, Q&A-2].
- Roth IRAs are funded with after-tax dollars, so that beneficiaries who inherit a Roth

IRA receive the assets tax-free. With a traditional IRA, income tax is due on the inherited money because the IRA is funded with pretax dollars.

The maximum total yearly contribution that can be made for 2008 by an individual to all IRAs (traditional and Roth) is the greater of \$5,000 or the taxpayer's "compensation" for that year [Reg. §1.408A-3, Q&A-3(c)]. Individuals who are age 50 by the end of the tax year may be able to make additional \$1,000 catch-up contributions to Roth IRAs for a total 2008 contribution of \$6,000 [Code Secs. 219(b)(5)(B), 414(v)(5)]. A contribution to a Roth IRA above the statutory limits generates a six-percent excise tax that is imposed each year until the excess contribution is eliminated [Code Sec. 4973].

A taxpayer whose modified adjusted gross income for a year does not exceed \$100,000 (and if married, files jointly) may convert an amount held in a non-Roth IRA (traditional IRA or SIMPLE IRA) to an amount

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

Elimination of Income Limits on Roth IRA Conversions in 2010

The \$100,000 AGI limit on the conversion of a traditional IRA to a Roth IRA is eliminated effective for tax years beginning after December 31, 2009 [Code Sec. 408A(c)]. For conversions in 2010, taxpayers can recognize conversion income ratably in 2011 and 2012. For conversions after 2010, all of the conversion income has to be recognized in the year of conversion [Code Sec. 408A(d)(3)(A)(iii)].

Converting Non-Roth IRA to Roth IRA

When a non-Roth IRA 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 traditional IRA 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) [Reg. §1.408A-4, Q&A 14(a)(1)]. To the extent an individual retirement annuity or an annuity contract held by an IRA 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) [Reg. §1.408A-4, Q&A 14(a)(2)].

Determining Fair Market Value

The following three methods are available to help taxpayers determine the fair market value of the annuities for purposes of determining the amount includible in gross income as a distribution [Reg. §1.408A-4, Q&A 14(b)]:

1. The gift tax method is based upon comparable contracts issued by the company that sold the annuity.
2. Where there is no comparable contract, fair market value can be established through an approximation based upon the interpolated terminal reserve at the date of conversion, plus the proportionate part of the premium paid before conversion covering a period after the date of conversion. 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.

3. A third method establishes the fair market value through a method that uses the accumulation of premiums as previously addressed in Rev. Proc. 2006-13, 2006-1 CB 315. Under the accumulation method, the fair market value of an annuity contract is determined using

the methodology provided in Reg. §1.401(a)(9)-6, A-12, with the following modifications. First, all front-end loads and other nonrecurring charges assessed in the 12 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 Reg. §1.401(a)(9)-6,

A-12(c)(1) and (c)(2), are not to be taken into account.

The final regulations apply 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, the valuation methods in the temporary regulations can be used for annuity contracts distributed or treated as distributed from a traditional IRA on or before December 31, 2008. ■