

Comment Letter on Roth IRA Guidance, December 1998

By Hand

December 2, 1998

Ms. Cathy Vohs
CC:DOM:CORP:R (REG- 115393 –98)
Courier's Desk
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C.

Re: Roth IRA Guidance

Dear Ms. Vohs:

I am writing on behalf of the Investment Company Institute¹ (the "Institute") in order to provide comments on the proposed regulations issued with respect to the Roth IRA (REG-115393-98), and Notices 98-49 and 98-50. Because financial institutions are trustees² for Roth IRAs and are responsible for reporting Roth IRA and traditional IRA contributions and distributions, the Institute has included comments with respect to IRA reporting requirements in addition to comments concerning the Roth IRA guidance contained in the proposed regulations.

We request that Treasury and the Internal Revenue Service address issues identified in this letter as expeditiously as possible for two reasons. First, with respect to reporting issues, our members face significant Y2K-related constraints on systems resources. Second, our member institutions need time to implement such Roth IRA guidance and train customer service personnel with respect to new rules in order to ensure proper communication of those rules to their customers.³ Therefore, we would urge the Service to issue any modifications related to 1999 IRA reporting by January 31, 1999. Finally, with regard to 1999 IRA reporting issues, we commend the Service for its timely release of Announcement 98-106 regarding 1999 Form 1099-R reporting.

For each issue we raise below, a specific recommendation is suggested and is followed by a discussion of the issue. After you and your colleagues have had the opportunity to review the issues we have identified in this letter, we would like to meet with you to discuss them. We will be in contact with you shortly to arrange such a meeting.

Notice 98-49

Recharacterization Transaction Reporting Requirements (Q&A B-1)

Issue: The proposal to report 1999 recharacterizations on a separate Form 5498 significantly alters the current Form 5498 reporting mechanism maintained by most financial institutions.

Recommendation: The Service should modify the 1999 Form 5498 by adding a box to report recharacterization amounts. Specifically, the Service should permit financial institutions to report 1999 recharacterization transactions using a single modified 1999 Form 5498, which would reflect recharacterization transaction amounts in a new reporting box.⁴

Discussion: Notice 98-49 Q&A B-1(2) states that it is anticipated that for 1999 recharacterization transactions, the trustee of the Second IRA will report the recharacterization contribution on a Form 5498 that is separate from any Form 5498 otherwise required for the Second IRA. Currently, many financial institutions report contributions to individual IRAs on a single Form 5498. Based on discussions with Institute members, we believe that changing current Form 5498 reporting systems to issue separate Forms 5498 will be significantly more difficult for many financial institutions than creating a new reporting box on the Form 5498.

The Service should maintain the integrity of the current reporting scheme relating to Form 5498 reporting and implement only minor

modifications to facilitate reporting of recharacterization transactions. The Institute recognizes the importance of separately identifying recharacterization contributions to an IRA. Indeed, current Form 5498 reports ensure that contributions to an individual's IRA are aggregated by contribution type. A consistent reporting regime should be established for recharacterizations. This may be accomplished by adding a "recharacterization amount" box to the 1999 Form 5498, rather than requiring the issuance of a separate Form 5498. Financial institutions would report contributions, rollover amounts and recharacterization amounts related to that IRA for the calendar year on a single Form 5498.

Adding a reporting box on the Form 5498 would require significantly less programming changes to financial institutions' reporting systems than designing a system that can issue more than one Form 5498 and, therefore, would be more cost effective. In light of the need for the industry's systems personnel to focus on Y2K computer compliance, we caution the Service against imposing such significant programming changes to satisfy 1999 reporting requirements.

The modified Form 5498 we suggest will be complemented by Form 8606 information concerning Roth IRA contributions, conversions and individual recharacterization transactions, which will be provided by the taxpayer. In total, these reports should provide sufficient information regarding IRA contributions to the Service.

Request for Comments Regarding Recharacterization Transactions

Issue: In addition to proposing issuance of separate Forms 5498 to report recharacterization transactions, the Service has requested comments on two reporting alternatives. Each alternative would represent a significant conceptual change to Form 5498 reporting and would require major systems changes.

Recommendation: As we discuss in above, the Service should maintain the integrity of the current Form 5498. Only minor modification—the addition of a "recharacterization" box—is needed to reflect recharacterization transactions. Financial institutions should be able to report 1999 recharacterization amounts on a single modified Form 5498.

Discussion: With respect to 1998 reporting for recharacterization transactions, Notice 98-49 provides a reporting mechanism that most closely approximates existing reporting for ordinary IRA distributions and contributions. That is, for each year, trustees report all reportable transactions based on the actual dollar amount of the transaction on the date of the particular transaction. The Institute supports maintaining the current Form 5498 reporting mechanism as much as possible while facilitating the reporting of recharacterization transactions.

In Notice 98-49, the Service proposed the following two reporting alternatives. Alternative One would require the Second IRA trustee to report the recharacterized contribution on a Form 5498 for the year for which it is treated as having been contributed, even if the recharacterization occurs in the subsequent year. Alternative Two would limit reporting to the trustee of the Second IRA involved in the recharacterization transaction to that which would have been required if the contribution had initially been made to the Second IRA and never had been made to the First IRA.

Form 5498 reporting currently provides "look back" capability only for IRA contributions of up to \$2,000 per year (up to April 15 for the previous year). All other IRA transactions are reported in the year effected. Because Forms 5498 are due May 31, contributions made through April 15 can be reflected on Forms 5498 for the previous year. Recharacterization transactions, however, may occur until the due date of the taxpayer's return including extensions. As a result, Alternative One would be problematic whenever a recharacterization transaction is executed after April 30 (for instance, when a recharacterization transaction occurs in October for the previous year). In these instances, trustees would have to manually "correct" previously issued Forms 5498.

In Alternative Two, the Service proposes that reporting of recharacterized transactions be limited to the trustee of the Second IRA. This proposed reporting scheme is undesirable for several reasons. First, similar to Alternative One, this approach is at odds with the basic premise of Form 5498 reporting—to report IRA transactions for a taxpayer effected by that trustee for a particular year and to reflect the amount involved at the time of the reportable transaction. Current reporting does not require "netting" of transactions. Under this proposal, subsequent IRA transactions, i.e., recharacterization transactions, would have to trigger a total voiding or adjustment of the reporting of an earlier, otherwise reportable transaction.

Second, trustees currently report transactions showing the actual amount involved on the date of the reportable transaction. Thus, for recharacterization transactions, the trustee of the Second IRA currently reports the actual amount recharacterized (i.e., the contribution or conversion amount net of gains or losses). Alternative Two would require the trustee of the Second IRA to report the amount of the original contribution or conversion and not the amount involved in the recharacterization transaction. In other words, the Second IRA trustee would report a different amount than the amount involved in the recharacterization transaction, because the recharacterized amount will rarely equal the actual amount of the contribution or conversion, i.e., the recharacterized amount will reflect gains or losses.

Third, an IRA trustee currently reports only reportable transactions that occur in its IRA accounts. There are no procedures or

systems in place to report transactions that occur in other trustees' accounts (e.g., if the original contribution or conversion and subsequent recharacterization involve different trustees).

Both alternatives would require Form 5498 reporting, which currently reports "snapshot transactions" or transactions at the time of contribution, to be altered to permit "look back" capability for recharacterization transactions or to provide "netting" capability for a contribution or conversion and subsequent recharacterization. Such conceptual changes to Form 5498 reporting would require significant programming and systems changes to Form 5498 systems maintained by financial institutions.

Service-Approved Roth IRA Documents

Issue: Modification of the Roth IRA model forms to permit commingling of Roth IRA contributions with conversion amounts.

Recommendation: The Service should issue guidance to enable taxpayers who previously executed a model Roth IRA form and checked the Roth Conversion IRA checkbox to deposit Roth IRA contributions in that "Conversion" account. In addition, the Service should clarify that financial institutions may designate Roth Conversion IRAs as commingled accounts pursuant to an amendment in Article IX of the model forms.

Discussion: The Service issued the model forms that may be used to establish a Roth IRA (Form 5305-R, Form 5305-RA and Form 5305-RB) in December 1997, prior to the passage of the technical corrections legislation. That legislation clarified that taxpayers could commingle their Roth IRA contributions and Roth IRA conversions in a single account. The model forms appear to prohibit such commingling in instances where a "Roth IRA Conversion IRA" check box was checked. Article I of the model forms states that "[i]f the Roth IRA is designated as a Roth Conversion IRA, no contributions other than IRA Conversion Contributions made during the same tax year will be accepted." In light of the legislative changes, many taxpayers would like to amend their Roth Conversion IRA account designation, (i.e., "uncheck" the check box) and commingle their Roth IRA contribution and conversion assets.

Q&A A-2 of Notice 98-49 addresses the issue of amending the Roth IRA model forms. It states that Article IX of the model forms permits certain amendments to be made to provisions of the Roth IRA in accordance with the instructions to the forms.⁵ Article VII of the model forms states, however, that notwithstanding amendments to the forms, Articles I through IV are controlling.

The Service should eliminate the checkbox on new model forms and provide guidance that would permit taxpayers to make Roth IRA contributions to any Roth IRA, whether or not it was previously designated as a "Roth Conversion IRA." In addition, the Service should clarify that financial institutions may redesignate a Roth Conversion IRA as a commingled account by an amendment in Article IX of the model forms.

Reporting Conversion Transactions Involving Withholding

Issue: How should conversion transactions that include withholding amounts be reported on Form 1099-R?

Recommendation: The Service should clarify that financial institutions should report 1999 conversion transactions for taxpayers under age 59 ½ on a single Form 1099-R using Code 1 for "early distribution, no known exception."

Discussion: The instructions to Form 1099-R currently require that the trustee report the amount being converted to a Roth IRA using Code 2 in box 7 (early distribution exception applies) if the owner is less than age 59 ½. This works well for conversions that do not involve withholding. In conversions involving withholding, however, it would be inappropriate to code the withholding amount as being exempt from the 10% premature distribution penalty if the IRA owner is less than 59 ½ years old. Therefore, for 1999 conversion transactions, the Institute supports a method whereby a single Form 1099-R is issued for the gross amount of these types of distributions. For conversion transactions that involve taxpayers under age 59 ½, the Institute supports reporting the distribution on Form 1099-R using Code 1 indicating "early distribution, no known exception." For conversions transactions for taxpayers over age 59 ½, the Institute supports relying on the current instructions to Form 1099-R, which require that trustees report the amount being converted using Code 7 (normal distribution).

Notice 98-50

Partial Recharacterizations

Issue: How does Notice 98-50's limitation on the number of reconversions apply to partial recharacterizations and reconversions?

Recommendation: The Service should clarify that Notice 98-50's limit on the number of reconversions applies to and is measured by the original contribution or conversion amount. Therefore, multiple partial recharacterizations and reconversions are permitted up to the original contribution or conversion amount, taking into account gains and losses. In addition, the Service should clarify that financial institutions are not responsible for tracking the number of reconversions executed by taxpayers.

Discussion: Notice 98-50 states that "[a] taxpayer 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 is eligible to reconvert that amount back to a Roth IRA once (but no more than once) on or after November 1, 1998 and on or before December 31; the taxpayer is also eligible to reconvert that amount once (but no more than once) during 1999." It is unclear what is meant by the term "that amount" in Notice 98-50.

The Service should clarify that for purposes of tracing sources of money with regard to the limitation on the number of reconversions, the term "that amount" refers to the original amount contributed or converted taking into account any applicable gains or losses. Therefore, taxpayers may execute multiple partial recharacterizations and reconversions that equal, but do not exceed, the amount of the original contribution or conversion, taking into account gains and losses attributable to that original amount. In addition, because recharacterization transactions and reconversions may occur between financial institutions as well as represent partial recharacterizations and reconversions within a Roth IRA account, financial institutions would be unable to track the number of reconversions executed by a taxpayer for purposes of Notice 98-50. Therefore, the Service should clarify that financial institutions are not responsible for tracking the number of reconversions executed by a taxpayer.

The following examples illustrate the issue:

Example 1: On November 5, 1998, taxpayer converts a traditional IRA valued at \$50,000 to a Roth IRA. On November 30, 1998, the value of that conversion Roth IRA account drops to \$40,000 and the taxpayer recharacterizes the Roth IRA account back to a traditional IRA. On December 21, 1998, the value of that traditional IRA increases to \$55,000 and the taxpayer reconverts.

Explanation: The reconversion of the \$55,000 is permitted because the taxpayer traces the source of the reconversion back to the original conversion amount of \$50,000. Therefore, under the limitation rule of Notice 98-50, the term "that amount" that is eligible for reconversion refers to the original \$50,000 conversion, taking into account any gains and losses. Although the reconversion involving \$55,000 is permitted, any subsequent recharacterization and reconversion of that account would be deemed an "excess conversion" under Notice 98-50.

Example 2: On November 2, 1998, taxpayer converts a traditional IRA valued at \$100,000 to a Roth IRA. On November 15, 1998, when the value of the conversion Roth IRA is \$100,000, the taxpayer recharacterizes \$40,000 of the Roth IRA to a traditional IRA. On November 30, 1998, when the value of the traditional IRA is \$45,000, the taxpayer reconverts the account to a Roth IRA. On December 5, 1998, when the value of the conversion Roth IRA is \$110,000, the taxpayer recharacterizes \$60,000 to a traditional IRA. On December 22, 1998, when the traditional IRA is valued at \$52,000, the taxpayer reconverts the amount to a Roth IRA.

Explanation: The recharacterizations and subsequent reconversions of the \$40,000/\$45,000 and \$60,000/\$52,000 amounts are permitted because taxpayers may recharacterize and reconvert amounts equal to and not to exceed the \$100,000 original conversion, including associated gains and losses. Any subsequent recharacterizations and reconversions relating to the original \$100,000 conversion would be deemed an "excess conversion" under Notice 98-50. However, if the taxpayer held additional IRA accounts, the limitation rules applicable to reconversions would apply separately to those amounts.

Proposed Regulations

Recharacterizations by Beneficiaries (1.408A-5)

Issue: Can a Roth IRA beneficiary recharacterize Roth IRA contributions and/or conversions executed by the deceased Roth IRA owner?

Recommendation: The Service should clarify that Roth IRA beneficiaries may recharacterize Roth IRA contributions and conversions executed by the deceased Roth IRA owner, subject to the recharacterization rules under the proposed regulations.

Discussion: Proposed regulation Section 1.408A-5 discusses the rules applicable to recharacterization transactions. However, the proposed regulations do not address whether a Roth IRA beneficiary may recharacterize a Roth IRA contribution or conversion executed by the Roth IRA owner. Roth IRA beneficiaries may find it necessary to recharacterize a traditional IRA or Roth IRA contribution for various reasons. For instance, following the death of the Roth IRA owner, a beneficiary may determine that the decedent's AGI was in excess of the contribution or conversion AGI limits applicable to Roth IRAs. A Roth IRA beneficiary may determine that a contribution or conversion to a Roth IRA was inappropriate for the deceased Roth IRA owner. Therefore, the Service should clarify that the recharacterization rules under the proposed regulations apply to both Roth IRA owners and beneficiaries.

Withholding Rules Applicable to Recharacterizations (1.408A-6, Q&As 12 & 13)

Issue: Do the withholding rules under Section 3405 apply to recharacterization transactions?

Recommendation: The Service should clarify that the withholding rules under Section 3405 do not apply to recharacterization transactions.

Discussion: The proposed regulations do not address whether the withholding rules apply to recharacterizations.⁶ A recharacterized contribution is treated as having been originally contributed to the Second IRA on the same date and for the same year that the contribution was made to the First IRA. Although a recharacterization is reported as a distribution, it is unlike a distribution because it does not result in taxable income to the taxpayer. Because withholding is relevant only where there is possible taxable income, the withholding rules applicable to IRA and Roth IRA distributions should not apply to recharacterization transactions.

Minimum Required Distributions and the Surviving Spouse (1.408A-6 Q&A-14(b))

Issue: The requirement that the surviving spouse be the sole beneficiary of his or her spouse's Roth IRA in order for the surviving spouse to treat the Roth IRA as his or her own or to elect to defer distributions until the year the decedent would have attained age 70½ is inconsistent with traditional IRA rules.

Recommendation: The Service should clarify that the surviving spouse need not be the sole beneficiary of his or her spouse's Roth IRA in order for the surviving spouse to treat the surviving spouse's portion of the Roth IRA as his or her own or to elect to defer distributions until the year the decedent would have attained age 70½.

Discussion: Neither Code Sections 408, 408A or 401(a)(9) or the proposed regulations under Section 401(a)(9) require the surviving spouse to be the sole beneficiary in order to elect to treat the decedent's IRA as his or her own IRA. Code Section 401(a)(9)(B)(iii)(I) and (II) use the phrases "any portion" and "such portion," respectively. Proposed Regulation Section 1.401(a)(9)-1, Q&A C-3 does not require the surviving spouse to be the sole beneficiary. And Proposed Regulation Section 1.408-8 Q&A 4 does not require the spouse to be the sole beneficiary to elect to treat the IRA as his or her own. Rather, it merely speaks in terms of "the beneficiary's entire interest in the trust" without regard to whether there are other beneficiaries.

Moreover, after an IRA accountholder dies, it is common practice to establish separate accounts for each of the IRA beneficiaries' portion of the decedent's account in cases where there is more than one beneficiary. In the absence of this practice, IRA accountholders wishing to have more than one beneficiary would establish and maintain separate IRAs—one for each designated beneficiary, which would be costly and inefficient. Consistent with this practice, the Service should not force Roth IRA accountholders who wish to designate multiple beneficiaries for their Roth IRA accounts to establish multiple accounts merely to enable the surviving spouse to elect to treat the decedent's IRA as his or her own or to elect to defer distributions until the year the decedent would have attained age 70½.

Decedents Who Die During 4-Year Spread for 1998 Conversions (1.408A-4, Q&A 11)

Issue: The rule in the proposed regulations that the surviving spouse must be the sole beneficiary of all of the decedent's Roth IRAs in order to elect to continue the 4-year spread of income for 1998 conversions is overly restrictive.

Recommendation: The Service should clarify that the surviving spouse may elect to continue the 4-year spread of income for any portion of the conversion Roth IRA inherited by the surviving spouse.

Discussion: Proposed regulation 1.408A-4, Q&A 11(b) states that if the sole beneficiary of all of the decedent's Roth IRAs is the decedent's spouse, then the spouse can elect to continue the 4-year spread of income. Therefore, if the decedent had other beneficiaries on any other Roth IRA, the surviving spouse could not elect to continue the 4-year spread of income for any 1998 Roth IRA conversions. This rule is overly restrictive for two reasons. First, IRA accountholders often have non-spousal beneficiaries, frequently their children, for some or all of their IRA accounts. This rule could significantly affect tax-planning issues with respect to IRA accounts and beneficiaries. Second, a spousal beneficiary of a Roth IRA will not always be aware of the existence of a non-spousal beneficiary designation with respect to a Roth IRA of the decedent. In such a case, the surviving spouse could elect to continue the 4-year spread of income in circumstances where he or she was ineligible to do so under the proposed regulations. Thus, the requirement that the surviving spouse must be the sole beneficiary of all of the decedent's Roth IRAs is overly restrictive and could result in unforeseen tax consequences to an innocent surviving spouse.

Conversions of SIMPLE IRAs (1.408A-4, Q&A 4)

Issue: If two or more employers' plan contributions are combined into one SIMPLE IRA, what measuring period is used for purposes

of converting to a Roth IRA?

Recommendation: The Service should clarify that the 2-year requirement relating to SIMPLE IRAs applies separately to the contribution of each of an individual's employers maintaining a SIMPLE IRA plan, even in instances where more than one employer's contributions are commingled in a single account. Finally, the Service should clarify that for purposes of this rule, a financial institution may rely on information provided to it by the taxpayer.⁷

Discussion: Proposed regulation 1.408A-4, Q&A 4 states that amounts distributed from a SIMPLE IRA during the 2-year period described in Section 72(t)(6) cannot be converted to a Roth IRA. This 2-year period applies separately to the contributions of each of an individual's employers maintaining a SIMPLE IRA plan for purposes of rollover to traditional IRAs under Code Section 408(d)(3) (G). It is unclear, however, whether the 2-year period applies separately to the contributions of each of an individual's employers maintaining a SIMPLE IRA in the case where both employers' contributions are commingled in a single account. In instances where taxpayers commingle SIMPLE IRA contributions related to multiple employers, the Service should provide taxpayers with an ordering rule for distributions. The Service should clarify that taxpayers are responsible for tracking the age of their SIMPLE IRAs.

Conclusion

The Institute respectfully requests that Treasury and the Service issue guidance concerning these Roth IRA issues to facilitate the maintenance and administration of Roth IRA accounts. As noted at the outset of this letter, we would like to meet with you and your colleagues to discuss these issues in the near future. In the interim, if you have any questions, please call Kathryn Ricard at (202) 218-3563 or Russ Galer at (202) 326-5835. Thank you for your attention to this matter.

Sincerely,

Kathryn A. Ricard
Assistant Counsel

cc: Michael Doran, Treasury Department
Carol Gold, IRS
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ENDNOTES

¹ The Investment Company Institute is the national association of the American investment company industry. Its membership includes 6,896 open-end investment companies ("mutual funds"), 436 closed-end investment companies, and 10 sponsors of unit investment trusts. Its mutual fund members have assets of about \$4.505 trillion, accounting for approximately 95% of total industry assets, and have over 62 million individual shareholders.

² The term "trustee" is used throughout this letter to refer to both trustees and custodians of Roth and Conversion Roth IRAs.

³ With regard to the limitations on reconversions imposed by Notice 98-50, which was issued on October 22, 1998, with an effective date of November 1, 1998, financial institutions are making their best efforts to educate their customers regarding this limitation. These education efforts include training customer service personnel, training brokers, posting information on company websites, etc. However, because the notice was effective almost immediately after issuance, financial institutions were unable to communicate this information via mass mailings to their customers. It is our understanding that for many financial institutions, the next major mailing of information will occur in January or February 1999. The Institute would like to make the Treasury Department and the Service aware that many taxpayers may not become aware of the limitation on reconversions until first quarter 1999.

⁴ The Service should permit financial institutions to have the option of using the approach described in Notice 98-49, in which a separate Form 5498 is issued for recharacterization transactions, provided that the use of a separate Form 5498 is voluntary.

⁵ Specifically, the notice provides the example that the sole beneficiary of a Roth IRA may elect not to treat the decedent's Roth IRA as his or her own through an amendment contained in Article IX.

⁶ Proposed regulation 1.408A-6, Q&As 12 & 13 state that the withholding rules under Section 3405 do apply to distributions from Roth IRAs, including Roth IRA conversions (except for trustee-to-trustee transfers involving Roth IRA conversions in 1998).

⁷ See Notice 98-4, SIMPLE IRA Plan Guidance, Q&A H-5 issued in December 1997.

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