2001

Professional's guide to the Roth IRA: implementing the 2001 tax act

Robert S. Keebler

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The Professional's Guide to the Roth IRA
Implementing the 2001 Tax Act

Robert S. Keebler, CPA, MST
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The Professional's Guide to the Roth IRA
Implementing the 2001 Tax Act

Robert S. Keebler, CPA, MST
Preface

Important changes have taken place since Congress created the Roth IRA in 1997. The Treasury Department finalized Roth IRA regulations and reproposed regulations governing qualified plans and all IRAs. In June 2001, President Bush signed into law the Economic Growth and Tax Relief Reconciliation Act of 2001 (2001 Tax Act), changing the landscape of estate planning, creating qualified Roth contribution programs, increasing annual IRA contribution limitations, and allowing additional makeup contributions for many taxpayers.

Perhaps equally important, the bull market of the 1990’s finally ended, producing sharp drops in the price of many stocks. Some market analysts believe that stock prices have reached their low point and should rebound strongly, making this the ideal time to make a Roth IRA conversion. The low stock prices should also encourage those who have already made a Roth conversion to recharacterize, eliminating the tax paid on the earlier conversion and allowing them to subsequently reconvert while the value of the IRA assets is low.

The 2001 Tax Act put in place dramatic changes in the credit shelter amount for the coming nine years, while the changes in the proposed IRA regulations allow for greater flexibility in planning IRA distributions. These developments grant our clients major opportunities to create and preserve wealth for their families. To achieve this goal, however, planners must understand the current and proposed status of the tax law to be able to design their clients’ plans to anticipate the potential benefits of the changes.

These developments have made it necessary to reexamine our clients’ existing Roth IRA planning. The Professional’s Guide to Roth IRAs: Implementing the 2001 Tax Act, based on and expanded from A CPA’s Guide to Making the Most of the New IRAs, 2nd edition, brings you, the planner, up to date and offers suggestions for planning in today’s changed legal and economic environment.
ACKNOWLEDGMENTS

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He would also like to thank, at the AICPA, Murray B. Schwartzberg, Esq. (now retired), for his continued guidance and encouragement, Michael J. Doyle for overseeing the publication, and Mary Mooney for her editing.
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He is a member of American College of CLU, ChFC’s Nationally Recognized Speakers Bureau. Mr. Keebler authored the AICPA’s A CPA’s Guide to Making the Most of the New IRAs (first and second editions). He is also the co-author of an AICPA national CPE course titled “Planning Strategies for Payouts From Qualified Retirement Plans and IRAs” and has written extensively on retirement distribution planning. Additionally, Mr. Keebler is the author of PPC’s Retirement Plan Distributions and Guide to Retirement Plan Distributions, Ranweilee Portfolio Series.

Mr. Keebler is a member of the editorial board of the American Society of CLU/ChFC’s Keeping Current series and is a featured columnist for CCH’s Taxes Magazine—“Family Tax Planning Forum.” He is frequently quoted in such national publications as The Wall Street Journal, Lawyer’s Weekly, USA Today, Wealth Manager, Worth, Kiplinger and Forbes, in addition to many local and regional newspapers. Mr. Keebler is a contributing author to Matthew Bender’s Treatise—“The Estate Tax Freeze—Tools and Techniques.”

Mr. Keebler is a graduate (cum laude) of Lakeland College with a degree in Accountancy and the University of Wisconsin–Milwaukee with a Masters in Taxation. Before practicing in Northeastern Wisconsin, he practiced with Price Waterhouse where he concentrated in taxation.
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INTRODUCTION TO THE

Roth IRA

chapter I
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Overview

Prior to the federal Economic Growth and Tax Relief Reconciliation Act of 2001 (the 2001 Act), there were the following three types of individual retirement accounts (IRAs):

- Traditional deductible IRAs
- Roth IRAs
- The traditional nondeductible IRA

The 2001 Act created a new type of elective deferral program known as Qualified Roth Contribution programs (applicable to tax years beginning in 2005). Additionally, the 2001 Act increases IRA contribution limits and provides an IRA catch-up provision.

Each IRA has unique rules that tax and financial planners (hereafter planners) need to understand.

Overview of the Roth IRA

The Taxpayer Relief Act of 1997 (the 1997 Act) introduced a new breed of IRA called the Roth IRA. The Roth IRA is a nondeductible IRA from which all future qualified distributions are not subject to income tax. Under certain circumstances, existing IRAs may be converted to Roth IRAs. The statutory guidance for the Roth IRA is covered under Internal Revenue Code (IRC) Section 408A. IRC Section 408A(a) provides that, except as provided under this Code section, the traditional IRA provisions continue to apply. Further, the 1997 Act provides that no deduction is allowed for Roth IRA contributions\(^1\) and that contributions must be made by the due date for filing the contributor's income tax return.\(^2\)

In addition, the maximum contribution that can be made to a Roth IRA is phased out for single taxpayers with an adjusted gross income (AGI) between $95,000 and $110,000 and for joint filers with an AGI between $150,000 and $160,000.\(^3\) The maximum contribution to a Roth IRA and traditional IRA cannot exceed the maximum contribution permitted to an IRA: generally, $2,000, except for taxpayers in the phase-out range.

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\(^1\) IRC Section 408A(c)(1).
\(^2\) IRC Section 219(f)(3).
\(^3\) IRC Section 408A(c)(3).
The 2001 Act increased the $2,000 IRA contribution limit as shown in table 1.1, "Increased Contribution Limits."

This has the effect of increasing the amount one can place in a Roth IRA as well. Despite the scheduled increases in contribution limits, Congress did not alter the AGI limitations.

Taxpayers with an AGI over the maximum contribution limitation are allowed to make traditional nondeductible IRA contributions.

■ Example: In 2001, John and Eva have an adjusted gross income (AGI) of $175,000. They are still allowed to make a $2,000 ($4,000 in total) nondeductible contribution to their IRAs.

When the Roth IRA is not available to a client, you should not overlook the opportunity to create wealth within the nondeductible IRA. Table 1.2, "Nondeductible IRA Versus Taxable Account Before Estate Tax," compares a nondeductible IRA with an outside investment account.

■ Example: Gerry is 22 years old and makes $2,000 annual contributions (subject to income tax at 28 percent) for forty years from 2001 to 2041. The invested funds grow at a 10-percent annual rate and the gains in the taxable account are subjected to a 22-percent capital gains rate.

IRC Section 408A(d)(1)(A) provides that any qualified distribution from a Roth IRA is not includible in gross income. Under the Act, a qualified distribution is a distribution that meets one of the following tests.

1. It is made on or after the day on which the taxpayer reaches age 59½.
   • Example: Dave has a Roth IRA with a basis of $40,000 and a fair market value of $100,000. At age 60, Dave takes a distribution of the entire $100,000, which is a qualified distribution and not subject to income or penalty taxes.

Table 1.1: Increased Contribution Limits

<table>
<thead>
<tr>
<th>Taxable Years</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002 through 2004</td>
<td>$3,000</td>
</tr>
<tr>
<td>2005 through 2007</td>
<td>$4,000</td>
</tr>
<tr>
<td>2008 and beyond</td>
<td>$5,000</td>
</tr>
</tbody>
</table>
2. It is made to a beneficiary (or to the taxpayer's estate) following the taxpayer's death. If the distribution is made within the five-taxable-year period beginning with the year the first contribution is made, the distribution is not a qualified distribution (see below).

• **Example:** Same as the preceding example, except Dave dies before taking the distribution. Because of Dave's death, any distribution from his Roth IRA is a qualified distribution. However, if Dave's wife were to roll these funds into her own IRA, the rollover IRA would be treated as her IRA, and distributions taken before she reaches age 59½ will not be qualified distributions.

3. It is attributable to the taxpayer's being disabled. (See IRC Section 72(m)(7) for the definition of disabled.)

• **Example:** Dave is disabled within the meaning of IRC Section 72(m)(7). In this instance, any distributions from the IRA are qualified distributions.

**Table 1.2: Nondeductible IRA Versus Taxable Account Before Estate Tax**

<table>
<thead>
<tr>
<th>Year</th>
<th>Nondeductible IRA</th>
<th>Taxable Account</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Annual Contribution¹</td>
<td>Annual Contribution</td>
</tr>
<tr>
<td>2001</td>
<td>$2,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>2006</td>
<td>$2,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>2011</td>
<td>$2,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>2016</td>
<td>$2,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>2021</td>
<td>$2,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>2026</td>
<td>$2,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>2031</td>
<td>$2,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>2036</td>
<td>$2,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>2041</td>
<td>$0</td>
<td>$0</td>
</tr>
</tbody>
</table>

¹ In all examples the contributions will be deemed to be made on the first day of the year.

² The net to family is an "as-if" calculation that liquidates the IRA every year subjecting it to income tax at 28 percent.

³ $2,000 annual contribution + $200 growth − $56 in tax at liquidation [($2,200 − $2,000) × 28 percent] = $2,144.

⁴ $2,000 annual contribution + $200 growth − $44 in tax at liquidation [($2,200 − $2,000) × 22 percent] = $2,156.
4. It is a qualified special-purpose distribution as defined in IRC Section 72(t)(2)(F): distributions for acquisition costs of named first-time home buyers.

It is important to understand that both requirements, the five-year holding period and satisfying one of the above criteria, must be met for the distribution to be a qualified distribution. A distribution that meets the five-year rule, but is not of the proper type is not a qualified distribution. Similarly, a distribution that is one of the proper types, but has not been held for five years is also not a qualified distribution.

Each Roth IRA owner has one five-year holding period that begins with either the year for which a contribution is first made to a Roth or the year in which the first dollar is converted from a traditional IRA to a Roth IRA. A subsequent conversion will not start the running of a new five-year holding period. The five-year clock starts ticking with the first conversion or contribution.

Example: Marcia, age 53, is thinking about rolling her 401(k) plan into a traditional IRA and then doing a conversion to a Roth IRA in seven years when she retires and is in a lower income tax bracket. She makes a contribution to a Roth IRA this year to get the clock started. Then, after she retires, all distributions will immediately be tax-free.

Nonqualified Distributions

Nonqualified distributions that do not meet the five-year holding period or are not made for one of the specified purposes are referred to as nonqualified distributions. Nonqualified distributions will be taxable income to the extent these distributions exceed basis.\(^8\) Basis can be defined as the amount converted from a traditional IRA to a Roth IRA and contributions made to a Roth IRA. There is an ordering rule for purposes of determining what portion of a nonqualified distribution is includible in income. Under this rule, distributions are treated as made from contributions first. Thus, no portion of a distribution is treated as attributable to earnings, or includible in gross income, until the total of all distributions from the Roth IRA exceeds the amount of contributions.\(^9\) A distribution is a nonqualified distribution if it is made within five years of the first contribution, or in the case of a conversion, if it occurs within five

\(^8\) IRC Section 408A(d)(1)(B).
\(^9\) IRC Section 408A(d)(4)(B)(I).
years of the conversion or does not otherwise meet the definition of a qualified distribution. 10

Example: Samantha, age 28, contributes $2,000 to a Roth IRA in 2000 and 2001. In 2007, Samantha withdraws $3,500 from her Roth IRA to make a down payment on a car. Although the distribution meets the five-year holding period, it is made prior to her reaching age 59 1/2 and is not made on account of death, disability, or as a first-time home buyer expense. Thus the distribution is nonqualified. However, because the amount withdrawn ($3,500) plus the amount previously withdrawn ($0) is less than the total amount contributed ($4,000), and no conversion contributions were made, the distribution is not subject to income taxation or penalties.

The contributions withdrawn first rule gives Roth owners greater flexibility than owners of regular nondeductible IRAs. In a regular nondeductible IRA, all withdrawals are deemed to be part earnings and part return of contributions. Roth IRA withdrawals are only subject to income tax after the amount that equals the amount contributed and converted has been withdrawn. In other words, only the earnings on Roth IRA contributions are subject to income tax at the time of a nonqualified distribution.

Table 1.3, “Contributory Roth IRA Distributions,” is a brief synopsis of the type of distribution, holding period, and income tax and penalty tax consequences.

Conversion of a Traditional IRA to a Roth IRA

The conversion of a traditional IRA to a Roth IRA is treated as a distribution in which the taxpayer recognizes taxable income. Had the taxpayer converted a traditional IRA to a Roth IRA in 1998, the opportunity was available to recognize income ratably over a four-year period. 11 Conversions occurring after 1998 are not afforded this favorable tax treatment.

10 IRC Section 408A(d)(3)(F).
11 IRC Section 408A(d)(3)(A)(iii).
Table 1.3: Contributory Roth IRA Distributions

<table>
<thead>
<tr>
<th>Distribution</th>
<th>Holding Period</th>
<th>Taxable</th>
<th>Penalty</th>
</tr>
</thead>
<tbody>
<tr>
<td>On or after age 59½</td>
<td>5 or more years</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Owner’s Death</td>
<td>5 or more years</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Owner’s Disability</td>
<td>5 or more years</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>First-Time Home Buyer</td>
<td>5 or more years</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>On or after age 59½</td>
<td>Less than 5 years</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Owner’s death</td>
<td>Less than 5 years</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Owner’s disability</td>
<td>Less than 5 years</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Before age 59½ and not an exception</td>
<td>5 or more years</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Before age 59½ and not an exception</td>
<td>Less than 5 years</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Annuited</td>
<td>Any period</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Used to pay certain medical expenses</td>
<td>Any period</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Used to pay qualified education expenses</td>
<td>Any period</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Used to defray health insurance costs for the unemployed</td>
<td>Any period</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

Converting Nondeductible Traditional IRAs to a Roth IRA

A taxpayer who considers converting nondeductible traditional IRAs to a Roth IRA must also be concerned with a partial conversion. If all the taxpayer’s IRAs are converted to a Roth IRA, there is no issue of how to calculate the taxable portion of the converted amount. If the taxpayer chooses to do only a partial conversion or chooses to convert only one of several IRAs, it is important to recognize that all IRAs are treated as one contract for tax purposes. Thus, a taxpayer may not convert only a nondeductible IRA or a portion of a nondeductible IRA and offset the basis against only that portion. Instead, the taxpayer must prorate the nondeductible amount over the total amount in all of the taxpayer’s IRAs.

Example: Joan has two traditional IRAs: a deductible IRA with a value of $10,000 and a nondeductible IRA with a value of $10,000 and a basis of $4,000 representing her nondeductible contributions. She converts only the nondeductible IRA to a Roth IRA. For tax purposes, she has one IRA with a value of $20,000 and a basis of $4,000. Since she is converting one-half of the aggregate value of the IRAs, the amount of basis allocated to the conversion is $2,000 (one-half of $4,000). Thus, she would recognize income of $8,000 ($10,000 conversion less $2,000 basis).

There is no prohibition against conversion after one’s required beginning date.
**Example:** Sylvia, age 75, has $200,000 in her IRA. In 2001 she withdraws her 2001 required minimum distribution (RMD) and makes a conversion election.

Income on post-1998 conversions is recognized in the year of conversion.\(^{12}\)

**Example:** Michael has $200,000 in his IRA. In 2001, he makes a conversion election and recognizes ordinary income of $200,000. The four-year spread is not available for conversions after December 31, 1998. However, Michael could simply convert $50,000 a year for four years.

Existing IRAs can be converted to Roth IRAs unless the following occur.

1. A taxpayer’s AGI exceeds $100,000. AGI for this purpose is the taxpayer’s AGI on Form 1040 (which includes application of the taxability of Social Security and the application of passive loss limitations) increased by the income from U.S. Savings Bonds used to pay higher education fees, employer-paid adoption expenses, and any foreign income excluded under IRC Section 911.\(^{13}\)

   • **Example:** Gary and Barb have AGI of $90,000 (before the conversion election). They elect to convert $500,000 of existing IRAs to a Roth IRA. Gary and Barb can elect to convert. The conversion income is not counted for purposes of the $100,000 Roth IRA conversion limitation.

   In addition, a taxpayer’s RMD is included in AGI for purposes of the $100,000 AGI limitation. However, Congress did modify the term AGI to not include RMDs, but only for tax years beginning after December 31, 2004.

2. The taxpayer is married and filing separately.\(^{14}\)

A Roth IRA is not subject to RMDs during the taxpayer’s lifetime.\(^{15}\) This suspension of the RMD rules is available for Roth IRAs created with annual contributions and from Roth IRAs created by rollovers of traditional IRAs.

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\(^{12}\) IRC Section 408A(3)(A).

\(^{13}\) IRC Section 408A(c)(3)(B)(i).

\(^{14}\) IRC Section 408A(c)(3)(B)(ii).

\(^{15}\) IRC Section 408A(c)(5).
Example: Harry, age 69, converts his traditional IRA to a Roth IRA. After a Roth conversion, no minimum distributions are required during Harry’s lifetime. Taxpayers are allowed to make contributions to a Roth IRA after age 701/2 if the taxpayer has earned income.16

Example: John, age 71, is still working and earning $40,000 annually. John can continue to make contributions to a Roth IRA. Because of the $100,000 AGI limitation, proper planning can open the door to a conversion election. Taxpayers can shift income into the next year, thereby reducing their AGI below $100,000. Therefore, planners should make their clients aware of this planning opportunity, so they can take steps to keep their AGI below the $100,000 limit by deferring income into the following year.

Idea for Managing Income

The following are available techniques and considerations that can be used to keep a taxpayer’s AGI below $100,000.

Deferring Income

The following are ways to defer income.

- Avoid regular IRA distributions.
- Convert taxable bonds to municipal bonds.
- Enter into deferred compensation agreements.
- Purchase certificates of deposits (CDs) and one-year Treasury bills (to defer income to January 2 of the following year).
- Avoid recognizing capital gains during the current year.
- Defer beginning Social Security payments.
- Purchase a tax-deferred annuity.
- Harvest or generate losses during the current year.

16 IRC Section 408A(c)(4).
Maximizing Adjustments to Income (Reduce AGI)

The following maximize adjustments to income and reduce AGI:

- Traditional IRA deductions
- Moving expenses
- One-half of self-employment tax
- Self-employed health insurance deduction
- Keogh and self-employed simplified employee pension (SEP) plans
- Penalty on early withdrawal of savings
- Alimony payments

Advanced Planning Opportunity—Reducing AGI

In 1986, IRC Section 469 was introduced to prevent taxpayers from reducing income by generating passive losses. However, IRC Section 469 contains a critical exception which states that “the term passive activity shall not include any working interest in any oil or gas property which the taxpayer holds directly or through an entity which does not limit the liability of the taxpayer with respect to such interest.”

Therefore, this provision allows a general partner of an oil and gas venture to invest in oil and gas and receive passive losses which may reduce AGI for purposes of the $100,000 AGI threshold. In order for this strategy to work, the taxpayer will need to ensure that the partnership is valid and that the partnership actually incurred the drilling costs in the year the deduction is being claimed.

Potential Problems—Resolved

Consider the following examples.

1. Following the conversion of a traditional IRA to a Roth IRA in 2001, AGI inadvertently exceeded $100,000.

Example: Richard and Mary project their 2001 AGI to be $70,000. In January 2001, they convert their $500,000 traditional IRA to a Roth IRA. In December, Richard and Mary win the lottery, which pushes their AGI for 2001 over the $100,000 AGI limit. Richard and Mary are allowed to...
transfer, in a trustee-to-trustee transfer, the converted amount back to the traditional IRA by the extended due date of the taxpayer's income tax return. This is termed a recharacterization.

The proposed regulation provisions allow a taxpayer to recharacterize a contribution or conversion by the extended due date of the taxpayer's income tax return. These regulations provide the following guidance with regard to the recharacterization:18

Example: In 2001, Individual C converts the entire amount in his traditional IRA to a Roth IRA. Individual C thereafter determines that his modified AGI for 2001 exceeded $100,000 so that he was ineligible to have made a conversion in that year. Accordingly, prior to the due date (plus extensions) for filing the individual's federal income tax return for 2001, he decides to recharacterize the conversion contribution. He instructs the trustee of the Roth IRA (first IRA) to transfer in a trustee-to-trustee transfer the amount of the contribution, plus net income, to the trustee of a new traditional IRA (second IRA). The individual notifies the trustee of the first IRA and the trustee of the second IRA that he is recharacterizing his IRA contribution. On the individual's federal income tax return for 2001, he treats the original amount of the conversion as having been contributed to the second IRA and not the Roth IRA. As a result, for federal tax purposes, the contribution is treated as having been made to the second IRA and not to the Roth IRA. The result would be the same if the conversion amount had been transferred in a tax-free transfer to another Roth IRA prior to the recharacterization.

Example: In 2001, an individual makes a $2,000 regular contribution for 2001 to his traditional IRA (first IRA). Prior to the due date (plus extensions) for filing the individual's federal income tax return for 2001, he decides that he would prefer to contribute to a Roth IRA instead. The individual instructs the trustee of the first IRA to transfer in a trustee-to-trustee transfer the amount of the contribution, plus attributable net income, from the trustee of the first IRA to the trustee of a Roth IRA (second IRA). The individual notifies the trustee of the first IRA and the trustee of the second IRA that he is recharacterizing his $2,000 contribution for 2001. On the individual's federal income tax return for 2001, he treats the $2,000 as having been contributed to the Roth IRA for 2001 and not to the traditional IRA. As a result, for federal tax purposes,

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17 IRC Section 408A(d)(6).
the contribution is treated as having been made to the Roth IRA for 2001 and not to the traditional IRA. The result would be the same if the conversion amount had been transferred in a tax-free transfer to another traditional IRA prior to the recharacterization.

**Example:** The facts are the same as in the preceding example, except that the $2,000 regular contribution is initially made to a Roth IRA and the recharacterizing transfer is made to a traditional IRA. On the individual’s federal income tax return for 2001, he treats the $2,000 as having been contributed to the traditional IRA for 1998 and not the Roth IRA. As a result, for federal tax purposes, the contribution is treated as having been made to the traditional IRA for 2001 and not the Roth IRA. The result would be the same if the contribution had been transferred in a tax-free transfer to another Roth IRA prior to the recharacterization, except that the only Roth IRA trustee the individual must notify is the one actually making the recharacterization transfer.

**Example:** In 2001, an individual receives a distribution from traditional IRA 1 and contributes the entire amount to traditional IRA 2 in a rollover contribution described in Section 408(d)(3). In this case, the individual cannot elect to recharacterize the contribution by transferring the contribution amount, plus net income, to a Roth IRA, because an amount contributed to an IRA in a tax-free transfer cannot be recharacterized. However, the individual may convert (other than by recharacterization) the amount in traditional IRA 2 to a Roth IRA at any time, provided the rollover rules are satisfied.

Converting to the Roth IRA raises the issue of timing. Under the original proposed regulations, a taxpayer could convert to a Roth IRA, recharacterize that contribution back to a traditional IRA, and then reconvert to the Roth IRA and pay tax on the second Roth IRA conversion. This was desirable because the taxpayer could save substantial taxes by reconverting to the Roth IRA if the assets declined in value. However, the final Roth IRA regulations prohibit this type of transaction. Treasury Reg. § 1.408A-5, Q&A 9 states the following.

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 the Roth IRA or, if later, the end of the thirty-day period beginning on the day on which the IRA owner
transfers the amount from the Roth IRA back to the traditional IRA by means of a recharacterization.

The essence of this provision is that if a taxpayer converts to a Roth IRA early in the year, the taxpayer will not be able to recharacterize this amount back to a traditional IRA and then convert back to a Roth IRA in the same year. This provision eliminates the opportunity to convert and reconvert in the same taxable year in order to achieve a lower tax liability. However, this recharacterization still allows a taxpayer to recharacterize a Roth conversion by the extended due date of the income tax return for any reason.

In May of 1999, the IRS issued IRS Announcement 99-57 which allowed a taxpayer, who had converted to a Roth IRA and who had timely filed the tax return, the ability to recharacterize all or a portion of that amount back to a traditional IRA by the extended due date for the taxpayer's income tax return.\textsuperscript{19} Even though the Announcement refers to the 1998 tax year, there is no indication that this would not apply going forward.

\textbf{Basic Roth IRA Examples}

Tom and Sue, both age 30, make nondeductible Roth IRA contributions from 2001 to 2041. Table 1.4, "The Roth IRA Versus the Traditional IRA—Net to Family Before Estate Tax," compares the Roth with the traditional IRA.

When the tax bracket remains the same and distributions are not taken into account there is no difference. However, required minimum distributions (RMD), estate taxes, bracket run, and paying the conversion taxes with outside assets will make the Roth IRA more desirable.

\textbf{Example:} Ron, age 60, makes nondeductible Roth IRA contributions from 2001 to 2010. Table 1.5, "Roth IRA," shows the value of the Roth IRA.

\textsuperscript{19} IRS Announcement 99-57, 1999-24 IRB 1 (May 26, 1999).
Table 1.4: The Roth IRA Versus the Traditional IRA—Net to Family Before Estate Tax

<table>
<thead>
<tr>
<th>Year</th>
<th>Age</th>
<th>Roth IRA</th>
<th>Traditional IRA</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>30</td>
<td>$2,200</td>
<td>$2,188</td>
</tr>
<tr>
<td>2006</td>
<td>35</td>
<td>$16,974</td>
<td>$16,628</td>
</tr>
<tr>
<td>2011</td>
<td>40</td>
<td>$40,769</td>
<td>$39,295</td>
</tr>
<tr>
<td>2016</td>
<td>45</td>
<td>$79,089</td>
<td>$74,945</td>
</tr>
<tr>
<td>2021</td>
<td>50</td>
<td>$140,805</td>
<td>$131,112</td>
</tr>
<tr>
<td>2026</td>
<td>55</td>
<td>$240,200</td>
<td>$219,755</td>
</tr>
<tr>
<td>2031</td>
<td>60</td>
<td>$400,276</td>
<td>$359,872</td>
</tr>
<tr>
<td>2036</td>
<td>65</td>
<td>$658,079</td>
<td>$581,685</td>
</tr>
<tr>
<td>2041</td>
<td>70</td>
<td>$1,071,074</td>
<td>$931,129</td>
</tr>
</tbody>
</table>

#### Economics of Paying Income Tax on Conversions

**Tax Payment From Other Assets: The Preferred Solution**

The most powerful way to increase wealth transfer when making a Roth IRA election is to pay the income taxes with outside assets. This allows the entire amount of the IRA to remain in a tax-deferred investment that will not be subject to income tax in the future.

**Tax Payment From Inside the Roth IRA**

If a client does not have sufficient outside assets, Roth IRA funds may be the only source from which to pay taxes. It may be desirable in limited circumstances to pay taxes from within the Roth IRA. This should only be done if it is absolutely necessary. If a taxpayer who is older than age 59 1/2 takes a distribution from the Roth IRA within the first five years, there is no 10-percent penalty.

---

20 This example assumes no estate tax, 28-percent federal income tax rate, no state income tax, 10-percent growth on investments inside and outside the IRAs, and a 22-percent tax on outside assets.

21 This column assumes contributions of $2,000 from 2001 to 2041.

22 This column assumes contributions of $2,560 until 2021. The $2,560 contribution represents a $2,000 annual contribution to a deductible IRA plus $560 (2,000 X 28-percent tax rate) representing the tax savings.

23 $2,000 annual contribution + $200 growth at 10 percent. No income tax on liquidation because the IRA is a Roth IRA.

24 $2,000 annual contribution + $200 growth at 10 percent – $616 of taxes at a 28 percent tax rate at liquidation. Because the $2,000 is a pretax contribution there is an outside balance consisting of $560 ($2,000 X 28 percent). The tax savings, $560 annual tax savings + $56 of growth at 10 percent – $12 of taxes at a 22-percent tax rate. Therefore, the IRA balance ($2,000 + $200 – $616) plus the outside balance ($560 + $56 – $12) equals net to family of $2,188.
On the other hand, if the taxpayer is younger than age 59½, the 10-percent IRC Section 72(t) penalty applies.

**Tax Payment From a Traditional IRA**

This option is not the first choice, because the distribution is taxable for the year in which it is received. Furthermore, if the client is under the age of 59½, the 10-percent penalty tax may be imposed on early withdrawals.

**Partial Conversions**

In many cases, it is not feasible or desirable to convert a client's entire IRA. If this is the case, the most viable solution is to do a partial conversion. The amount of the rollover depends on a number of variables, such as the availability of cash to pay the taxes, the client's age, the client's current tax bracket versus expected future tax bracket, and the client's overall estate plan.
Introduction to the Roth IRA

Required Minimum Distributions

Congress recognizes that current RMDs may cause a taxpayer's AGI to be over $100,000 in the year of conversion. Their solution, however, addresses the problem, but only for years after 2004 when the required minimum distribution will not be included in AGI for purposes of the $100,000 limit. This provision will provide substantial opportunities after 2004 for those taxpayers whose AGI exceeds $100,000 primarily because of IRA income. Beginning after the year 2004, they will be able to convert their traditional IRA to a Roth IRA.

The ideal candidate for a Roth IRA conversion will be an individual who has outside funds to pay the taxes and will not need to take distributions after 70 1/2. One of the critical factors to analyze when addressing Roth IRA conversions will be changes in tax brackets. For example, if a taxpayer has to overcome a change from a 28-percent to 39.6-percent bracket to make a Roth conversion effective; it may be difficult to justify a conversion unless other estate planning circumstances come into play.

If a client will not need the funds from a traditional IRA after age 70 1/2, there may be some merit in converting to the Roth IRA even if the funds have to be taken from the Roth IRA or traditional IRA to pay the taxes. For example, if a client needs to fund his unified credit bypass trust with IRA assets and will not need to take funds from his traditional or ordinary IRA after age 70 1/2, a Roth IRA conversion should be carefully analyzed.

Death of the Roth IRA Owner Within the Four-Year Income Inclusion Period

Even though 1998 has passed, there are taxpayers who converted to a Roth IRA in 1998 and are taking advantage of the four-year spread. In the event the taxpayer dies during the four-year period, special rules apply.

If the taxpayer's spouse is the sole beneficiary of the Roth IRA, the spouse can continue the income deferral over the four-year income inclusion period. This refers to conversions to a Roth IRA in 1998 where income from the conversion is recognized over a four-year period.

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25 IRC Section 408A(c)(3)(C)(i)(II).
26 IRC Section 408A(d)(3)(E)(ii)(II).
If the spouse is not the sole beneficiary of the Roth IRA, the remaining income not previously recognized will be included on the decedent's final tax return. This will be the case if someone other than the spouse is the sole beneficiary of the Roth IRA or if the spouse is a cobeneficiary with another individual. 27

**Example:** Joe, age 65, names his spouse, Jill as the beneficiary of his $500,000 IRA. In 1998, he converts the IRA to a Roth IRA. Joe dies in 1999. Because Jill is the sole beneficiary of his Roth IRA, she can continue to pay the conversion taxes over the four years.

**Example:** Assume the same facts as the previous example except that Joe also designates that one percent of the Roth IRA should pass to his stepson. In this instance, because Jill is not the sole beneficiary, the income not recognized would be accelerated into 1999. This could have been avoided by splitting the Roth IRA into separate IRAs.

### REQUIRED DISTRIBUTIONS UPON THE DEATH OF THE ROTH IRA OWNER

At age 70 1/2 the owner of a Roth IRA does not have to take a required distribution. 28 In fact, if the Roth IRA owner chooses to never take a distribution from the Roth IRA during lifetime, the entire value of the IRA can continue to grow tax deferred until the owner’s death. However, Roth IRAs are subject to RMD rules upon the death of the owner unless the owner’s spouse is the sole beneficiary. If the surviving spouse is the sole beneficiary upon the Roth IRA owner’s death, the spouse will be treated as the owner of the inherited Roth IRA. 29 The benefit of having the surviving spouse treated as the owner of the Roth IRA is that the spouse, like the decedent, would not be required to take minimum distributions during lifetime. Thus, the Roth IRA could continue to grow tax-free during the lifetime of the surviving spouse.

If the Roth owner dies and the surviving spouse is not the sole beneficiary, the entire remaining value will have to be distributed as one of the following:

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28 IRC Section 408A(c)(5).
29 IRC Section 401(a)(9)(B); IRS Proposed Reg. § 408A-6, Q&A-14; Form 5305-R, Article V.
1. By December 31 of the year containing the fifth anniversary of the owner’s death
2. Over the life expectancy of the designated beneficiary starting no later than December 31 of the year following the year of the owner’s death

If distributions do not begin by December 31 of the year following the year of the Roth IRA owner’s death, then the entire balance must be distributed by December 31 of the year containing the fifth anniversary of the owner’s death. In other words, if the beneficiaries do not begin timely distributions under the life expectancy option, the distributions default to the five-year rule. Thus, to maximize the stretch-out from a Roth IRA, nonspouse beneficiaries should make certain that distributions start in the year after the owner’s death.

A Roth beneficiary who fails to take RMDs is subject to a 50-percent penalty tax on the amount that should have been withdrawn but was not.

Example: Susie is the beneficiary of her deceased mother’s Roth IRA. Susie is age 52 in the year 2000 (her first year of distribution) and the Roth IRA had a value of $100,000 on December 31, 1999. Susie is required to withdraw $3,194 ($100,000 divided by her life expectancy of 31.3 years). Susie failed to make the withdrawal. Therefore, she is subject to a penalty tax of $1,597. If she had taken a withdrawal of an amount less than $3,194, the difference would be subject to the 50-percent federal penalty tax.

Summary: Some Random Thoughts

From an estate-planning perspective, the Roth IRA has tremendous advantages—most notably are those taxpayers who need to fund their bypass trusts with either ordinary or Roth IRA assets. It will almost always be better to utilize a Roth IRA to fund one’s bypass trust because distributions from the Roth IRA are not subject to income tax.

The revised proposed IRA distributions regulations diminished some of the benefits of a Roth IRA relative to a traditional IRA. However, in many instances, the Roth IRA will continue to be superior.

The following are some general thoughts.

1. In most cases, it is advantageous for your clients to make a partial Roth IRA election.
2. The best way to pay the income taxes arising from the conversion is with high-basis outside funds.

3. In many situations, only a partial conversion is acceptable from a financial or cash flow perspective.

4. Consider establishing several IRAs with different sectors or industry groupings and convert each to separate Roth IRAs. By October of the following year, it can be decided which Roth IRAs should be recharacterized, leaving intact the Roth IRAs which performed well.
Changes Embodied in the Economic Growth and Tax Relief Reconciliation Act of 2001

Chapter II
EXPANSION OF THE TRADITIONAL DEDUCTIBLE IRA

The Economic Growth and Tax Relief Reconciliation Act of 2001 (the 2001 Act) expanded the amount a taxpayer can contribute to tax-deductible individual retirement accounts (IRAs). (See table 2.1, "New IRA Contribution Limits.") Under the old law, an individual could only make tax-deductible contributions to an IRA up to the lesser of $2,000 or their annual compensation.

**Table 2.1: New IRA Contribution Limits**

<table>
<thead>
<tr>
<th>Year</th>
<th>Deductible Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002 through 2004</td>
<td>$3,000</td>
</tr>
<tr>
<td>2005 through 2007</td>
<td>$4,000</td>
</tr>
<tr>
<td>2008 and beyond</td>
<td>$5,000</td>
</tr>
</tbody>
</table>

If a taxpayer, or his or her spouse, is an active participant in an employer-sponsored qualified retirement plan, the amount the participant can deduct for an IRA contribution is subject to certain adjusted gross income (AGI) limitations. The income phase-out limits increase gradually between 2001 and 2007. (See table 2.2, "Phase-Out Limits.")

**Table 2.2: Phase-Out Limits**

<table>
<thead>
<tr>
<th>Year</th>
<th>Individuals</th>
<th>Joint Filers</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>$33,000 to $43,000</td>
<td>$53,000 to $63,000</td>
</tr>
<tr>
<td>2002</td>
<td>$34,000 to $44,000</td>
<td>$54,000 to $64,000</td>
</tr>
<tr>
<td>2003</td>
<td>$40,000 to $50,000</td>
<td>$60,000 to $70,000</td>
</tr>
<tr>
<td>2004</td>
<td>$45,000 to $55,000</td>
<td>$65,000 to $75,000</td>
</tr>
<tr>
<td>2005</td>
<td>$50,000 to $60,000</td>
<td>$70,000 to $80,000</td>
</tr>
<tr>
<td>2006</td>
<td>$50,000 to $60,000</td>
<td>$75,000 to $85,000</td>
</tr>
<tr>
<td>2007</td>
<td>$50,000 to $60,000</td>
<td>$80,000 to $100,000</td>
</tr>
<tr>
<td>and beyond</td>
<td>$50,000 to $60,000</td>
<td></td>
</tr>
</tbody>
</table>

If a taxpayer is not considered an active participant in an employer-sponsored qualified retirement plan but his or her spouse is and they are filing a joint return, the IRA deduction for the nonparticipant spouse is phased out when AGI is between $150,000 and $160,000. If they are filing separately, the phase-out range is up to $10,000.

The new 2001 Act also allows a catch-up contribution for individuals who are age 50 years or older before the end of the taxable year. For these
individuals, the deductible amount will be increased by $500 in taxable years 2002 to 2005. For taxable years 2006 and beyond, the amount is increased by $1,000. For taxable years after 2008, the contribution limits will be adjusted for cost-of-living increases.
Tax Planning for the
Roth IRA Funded with
Annual Contributions

Chapter III
Under current law, taxpayers with adjusted gross income (AGI) below $150,000 (subject to a phase-in provision) are allowed to make annual contributions totaling $2,000 in 2001 to the Roth individual retirement account (IRA). Also, a husband and wife are able to make annual contributions of $4,000.

Example: Ron and Lynn are both employed and have been contributing to nondeductible IRAs. Instead, Ron and Lynn will now begin to contribute to a Roth IRA that has a 10-percent annual return. In fifteen years, their $4,000 annual contributions will have grown from their initial investment of $60,000 to approximately $130,000. Under the Roth IRA, the growth will never be subject to income tax provided the distributions are qualified.

Beginning in 2006, employees may make contributions to a Qualified Roth Contribution program established under a 403(b) plan or a 401(k) plan. See Internal Revenue Code (IRC) Section 402A. Employees may elect to make Roth contributions in lieu of all or a portion of elective deferrals that the employee is otherwise eligible to make under the applicable retirement plan. Unlike deferrals to a 403(b) plan and a 401(k) plan, elective deferrals to a Qualified Roth Contribution program are not income tax excludable.

If a client is currently making contributions to a nondeductible IRA, the decision to make the same contributions to a Roth IRA is relatively straightforward, unless the client plans on retiring or using the funds before age 59 1/2.

Generally, the Roth IRA creates considerably more wealth, as shown in table 3.1, “Roth IRA Versus Traditional IRA—Net to Family After Income and Estate Tax,” which assumes a 55-percent estate tax rate, a 28-percent federal income tax rate, and a 22-percent gains tax on outside assets, an IRC Section 691(c) income in respect of a decedent (IRD) deduction, no state income tax, 100-percent growth on investments inside and outside the IRAs, 100-percent turnover on outside assets, minimum

---

1 Annual contributions to Roth IRAs are limited to $2,000 less any deductible IRA contributions. (See IRC Section 408A(c)(2).) There is no prohibition on making Roth IRA contributions after attaining age 70 1/2. (See IRC Section 408A(c)(4).)

2 The maximum contribution that can be made to a Roth IRA is phased out for individual taxpayers with AGIs between $95,000 and $110,000 and for joint filers whose AGI is between $150,000 and $160,000. (See IRC Section 408A(c)(3)(C).)

3 The Economic Growth and Reconciliation Act of 2001 (the 2001 Act) increased contribution limits for subsequent years.
distributions from the traditional IRA at age 70½, and that the participant’s age in 2002 is 30. The annual contributions to the Roth IRA are $2,000 until 2041, and to the traditional IRA are $2,560 ($2,000 contribution to deductible IRA plus $560 [($2,000 × 28 percent tax] represents the income tax saving) until 2041.

Table 3.1: Roth IRA Versus Traditional IRA—Net to Family After Income and Estate Tax

<table>
<thead>
<tr>
<th>Year</th>
<th>Roth IRA</th>
<th>Traditional IRA</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>$9904</td>
<td>$9365</td>
</tr>
<tr>
<td>2007</td>
<td>$7,638</td>
<td>$7,102</td>
</tr>
<tr>
<td>2012</td>
<td>$18,346</td>
<td>$16,770</td>
</tr>
<tr>
<td>2017</td>
<td>$35,590</td>
<td>$31,954</td>
</tr>
<tr>
<td>2022</td>
<td>$63,362</td>
<td>$55,847</td>
</tr>
<tr>
<td>2027</td>
<td>$108,090</td>
<td>$93,509</td>
</tr>
<tr>
<td>2032</td>
<td>$180,124</td>
<td>$152,976</td>
</tr>
<tr>
<td>2037</td>
<td>$296,136</td>
<td>$247,017</td>
</tr>
<tr>
<td>2042</td>
<td>$481,983</td>
<td>$395,016</td>
</tr>
</tbody>
</table>

Penalty Tax

Younger taxpayers’ main problem with the Roth IRA is that Roth IRA distributions before age 59½ will be nonqualified distributions taxable as ordinary income to the extent they exceed basis. Thus, if a taxpayer takes a distribution before age 59½, the taxpayer is subject to a 10-percent penalty excise tax.⁶ If a taxpayer is fairly sure that he or she will not need the funds before age 59½, the Roth IRA represents a strong opportunity to

---

4 Suppose $2,000 annual contribution + $200 growth at 10 percent. There is no income tax on liquidation because the IRA is a Roth IRA. This also includes estate tax at 55 percent. $2,200 from Table 1.3 × (1 – 55 percent) = $990.

5 $2,000 annual contribution + $200 growth at 10 percent less $616 of taxes at a 28-percent tax rate at liquidation. Because the $2,000 is a pretax contribution, there is an outside balance consisting of $560 ($2,000 × 28 percent), the tax savings. There is a $560 annual tax savings + $56 of growth at 10 percent less $12 of taxes at a 22-percent tax rate. Therefore, the IRA balance ($2,000 + $200 – $616) plus the outside balance ($560 + $56 – $12) equals net to family of $2,188. This also includes estate tax and the IRC Section 691(c) deduction for federal estate taxes paid with regard to income in respect of a decedent. There is a $2,200 ending IRA balance before income tax + $604 ending outside balance = $2,804 ending IRA and outside balance. $2,804 × 55 percent estate tax rate = $1,542 estate tax. The amount attributable to the IRA is $2,200 × 47 percent federal estate tax rate (assumes 8 percent is attributable to the state death tax) = $1,034. Therefore, the income tax with regard to the IRA is ($2,200 IRA balance – $1,034 IRC Section 691(c) deduction) × 28-percent income tax rate = $326. The ending balance of IRA and outside account is $2,804 – estate tax of $1,542 – income tax of $326 = $936.

6 IRC Section 72(t).
accumulate funds for retirement. The taxpayer will be able to avoid the 10-percent penalty by taking substantially equal periodic payments (SEPP). Note that the 10-percent penalty tax also applies to the nonqualified distributions of after tax return of basis if either of the following occurs.

1. Any portion of the distribution is allocable to a rollover contribution created by the conversion of a traditional IRA.
2. The distribution occurs within a five-year taxable period beginning with the contribution.\(^7\)

\(^7\) IRC Section 408A(d)(3)(F).
Conversion of Existing IRAs to Roth IRAs

chapter IV
The conversion of existing individual retirement accounts (IRAs) to Roth IRAs is one of the most complex issues confronting planners. To completely understand the options available to clients, you should start with a review of the Internal Revenue Code (IRC) provisions governing the conversion of a traditional IRA to a Roth IRA.

Perhaps the most cumbersome requirement is the $100,000 adjusted gross income (AGI) limitation.¹ If a taxpayer's AGI is either definitely going to be under $100,000, or can be kept under $100,000 through planning, a conversion to a Roth IRA should be considered. If converting is desirable, AGI can be managed if possible.

Managing Investment Portfolio Income to Reduce Taxation

As discussed in chapter 1, "Introduction to the Roth IRA," there is a new opportunity for a taxpayer who is a general partner in an oil and gas venture. Tax law allows a general partner in an oil and gas venture to deduct the amount of intangible drilling costs in the year these expenses are incurred. Therefore, a taxpayer could reduce his AGI for purposes of a Roth IRA conversion using this technique.

At first glance, many taxpayers apparently cannot make the election to convert their traditional IRA to a Roth IRA. However, if your careful analysis of your client's income shows that it is possible to shift income from the current year to the next, your client may decide to do so. This involves traditional income-tax shifting techniques that many planners have used over the years. The following is an outline of a number of ideas that may be helpful to reduce a client's AGI.

- Avoid regular IRA distributions.
- Convert taxable bonds to tax-free municipal bonds.
- Modify or create deferred-compensation agreements.
- Purchase certificates of deposit or one-year Treasury bills designed to defer income to January of the following year.
- Avoid capital gains.
- Defer beginning Social Security.

¹ See IRC Section 408A(c)(3)(B)(I). Under this provision, actual AGI is increased by specified IRC Section 911 foreign-income items, and the exclusions for U.S. Savings Bond interest used for educational expenses and employer-paid adoption assistance.
Example: Brian, age 60, is retired and expects to have a 2001 income of approximately $120,000. Included in this income will be $60,000 of taxable bond interest income. To reduce Brian and his wife’s income for one year, they may wish to convert their existing bond holdings to municipal bonds.

Example: Same as the preceding example, except Brian is currently negotiating a post-retirement deferred-compensation agreement. Structuring the post-retirement deferred-compensation agreement to defer income beyond 2001 would work to keep Brian’s income below $100,000.

Another choice facing planners and their clients is the advisability of converting all or a portion of an existing IRA to a Roth IRA. Neither the Act nor its legislative history indicate that a taxpayer must convert 100 percent of his or her current IRAs to Roth IRAs. Apparently, a taxpayer should be able to transfer funds from an existing IRA to a Roth IRA (in a trustee-to-trustee transfer) and subsequently convert the newly created IRA to a Roth IRA. Although a somewhat complex mathematical puzzle, this move allows the taxpayer to optimize a percentage of his or her existing IRA that should be converted to a Roth IRA. Among the considerations regarding the amount to convert are the following:

- The taxpayer’s current income tax situation and projected income tax situation for the next five years
- The impact on the taxation of current and future Social Security benefits
- The impact on estate planning
- The need or lack of need to fund the family trust (for example, a unified credit bypass trust) with IRA assets
- The outside assets available to fund the tax liability incurred by making a Roth IRA election
- Converting before beginning to receive Social Security benefits

The following six distinct estate and income tax planning considerations support converting to a Roth IRA.

1. The taxpayer has a special tax attribute available. For example, he or she may have charitable deduction carryforwards or investment tax credits.
2. Suspension of the minimum distribution rules at age 70 1/2 provides a considerable advantage to the Roth IRA holder. See table 4.1, "Traditional IRA Versus Roth IRA—No Estate Tax and Tax Payment From Outside Funds."

3. The payment of income tax before the imposition of estate tax (when a Roth IRA election is made), compared with the available income in respect of a decedent (IRD) deduction when a traditional IRA is subject to estate tax provides a moderate benefit.²

4. Taxpayers who can pay the income tax resulting from a Roth IRA election from non-IRA funds will benefit greatly from the Roth IRA. See table 4.2, "A Traditional IRA Versus Roth IRA."

5. Taxpayers who need to use IRA funds to fund their applicable exclusion bypass trust are well advised to consider electing a Roth IRA for that portion of their overall IRA funds used to fund the trust.

6. Taxpayers who make the Roth IRA election during their lifetimes will reduce their overall estates, thereby lowering the effect of higher estate tax rates.

**Table 4.1: Traditional IRA Versus Roth IRA—No Estate Tax and Tax Payment From Outside Funds³**

<table>
<thead>
<tr>
<th>Year</th>
<th>Ending IRA and Outside Fund Balance</th>
<th>Taxes on IRA</th>
<th>Net to Family</th>
<th>Ending IRA and Outside Fund Balance</th>
<th>Taxes on IRA</th>
<th>Net to Family</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan. 1, 2001</td>
<td>$750,000</td>
<td>($140,000)</td>
<td>$610,000</td>
<td>$750,000</td>
<td>($140,000)</td>
<td>$610,000</td>
</tr>
<tr>
<td>Dec. 31, 2001</td>
<td>$820,000</td>
<td>($154,000)</td>
<td>$666,000</td>
<td>$668,800</td>
<td>$0</td>
<td>$668,800</td>
</tr>
<tr>
<td>Dec. 31, 2006</td>
<td>$1,282,499</td>
<td>($248,019)</td>
<td>$1,034,481</td>
<td>$1,060,337</td>
<td>$0</td>
<td>$1,060,337</td>
</tr>
<tr>
<td>Dec. 31, 2011</td>
<td>$2,009,468</td>
<td>($399,436)</td>
<td>$1,610,032</td>
<td>$1,683,039</td>
<td>$0</td>
<td>$1,683,039</td>
</tr>
<tr>
<td>Dec. 31, 2016</td>
<td>$3,153,972</td>
<td>($643,296)</td>
<td>$2,510,676</td>
<td>$2,674,340</td>
<td>$0</td>
<td>$2,674,340</td>
</tr>
<tr>
<td>Dec. 31, 2021</td>
<td>$4,958,583</td>
<td>($1,036,035)</td>
<td>$3,922,548</td>
<td>$4,253,847</td>
<td>$0</td>
<td>$4,253,847</td>
</tr>
<tr>
<td>Dec. 31, 2026</td>
<td>$78,808,177</td>
<td>($1,668,545)</td>
<td>$6,139,632</td>
<td>$6,772,687</td>
<td>$0</td>
<td>$6,772,687</td>
</tr>
<tr>
<td>Dec. 31, 2031</td>
<td>$12,314,089</td>
<td>($2,687,208)</td>
<td>$9,626,881</td>
<td>$10,792,615</td>
<td>$0</td>
<td>$10,792,615</td>
</tr>
</tbody>
</table>

² IRC Section 691(c).
³ IRC Section 691(c).
Table 4.2: A Traditional IRA Versus Roth IRA

<table>
<thead>
<tr>
<th>Year</th>
<th>Traditional IRA</th>
<th>Roth IRA</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Ending IRA and Outside</td>
<td>Taxes on IRA</td>
</tr>
<tr>
<td>Jan. 1, 2001</td>
<td>$750,000</td>
<td>($140,000)</td>
</tr>
<tr>
<td>Dec. 31, 2001</td>
<td>$820,000</td>
<td>($154,000)</td>
</tr>
<tr>
<td>Dec. 31, 2006</td>
<td>$1,282,499</td>
<td>($248,019)</td>
</tr>
<tr>
<td>Dec. 31, 2011</td>
<td>$2,009,468</td>
<td>($399,436)</td>
</tr>
<tr>
<td>Dec. 31, 2016</td>
<td>$3,153,972</td>
<td>($643,296)</td>
</tr>
<tr>
<td>Dec. 31, 2021</td>
<td>$4,958,583</td>
<td>($1,036,035)</td>
</tr>
<tr>
<td>Dec. 31, 2026</td>
<td>$7,808,177</td>
<td>($1,668,545)</td>
</tr>
<tr>
<td>Dec. 31, 2031</td>
<td>$12,314,089</td>
<td>($2,687,208)</td>
</tr>
</tbody>
</table>

As already discussed, taxpayers who need to use retirement assets to fund a unified credit trust are well advised to consider the following strategy: to the extent that their overall income tax rate will not be unduly increased, the taxpayer should consider converting up to the applicable exclusion amount of a traditional IRA to a Roth IRA. The amount in the Roth IRA can then be used to fund the taxpayer's unified credit bypass trust. Figure 4.3, "Roth IRA Versus Traditional IRA After the Death of an Account Holder," illustrates an example of using a Roth IRA (from which taxes have already been paid) compared with a traditional IRA. The computation assumes a $675,000 beginning balance with a beneficiary who...

Figure 4.3: Roth IRA Versus Traditional IRA After the Death of Account Holder

<table>
<thead>
<tr>
<th>Year</th>
<th>Ending Outside and IRA Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Roth IRA</td>
</tr>
<tr>
<td>2001</td>
<td>$742,500</td>
</tr>
<tr>
<td>2006</td>
<td>$1,195,804</td>
</tr>
<tr>
<td>2011</td>
<td>$1,925,854</td>
</tr>
<tr>
<td>2016</td>
<td>$3,101,607</td>
</tr>
<tr>
<td>2021</td>
<td>$4,995,169</td>
</tr>
<tr>
<td>2026</td>
<td>$8,044,769</td>
</tr>
<tr>
<td>2031</td>
<td>$12,956,181</td>
</tr>
<tr>
<td>2036</td>
<td>$20,866,059</td>
</tr>
</tbody>
</table>

4 This assumes the Roth IRA election is made on January 1, 2001, and the entire tax liability for that year is withdrawn from the Roth IRA. It also assumes growth of 10 percent; income tax of 28 percent; and capital gains rates of 20 percent; a 100 percent turnover of outside investments; and that there is no estate tax.

5 The IRC Section 691(c) deduction is not available because a federal estate tax has not been incurred.
is age 50; distributions from the IRAs begin in 2001 and are based on a 34.0-year life expectancy; growth both inside and outside the IRA is 10 percent with the outside growth being subject to capital gains tax at 22 percent, and a 28 percent federal income tax rate. There is no federal income tax on Roth IRA distributions.

---

**Whether to Convert From a Traditional IRA to a Roth IRA**

Making the decision to convert is more than a mathematical or analytical question; it must be addressed holistically, taking into account a client’s financial, retirement, income tax, and estate planning. Having analyzed the Taxpayer Relief Act of 1997 and the related computations during the time since passage, the author is reasonably certain that most individuals with more than $250,000 in their plans should convert a portion of that plan to a Roth IRA. This holds true to an even greater extent for individuals who have in excess of $1 million in their plan and to a lesser, but still significant, degree for those taxpayers with smaller IRAs.

To understand the conversion analysis, you should begin with the basic computations.

**Example:** Sue has $500,000 in her IRA, which could remain a traditional IRA from the years when Sue is age 60 to age 90, or it could be fully converted to a Roth IRA. For ease of analysis, the assumption is that the dollars will be taxed at 28 percent in both instances. As table 4.2, "A Traditional IRA Versus Roth IRA," shows, there is no difference between converting or not converting.

Because there is no difference, are there other factors that may drive the conversion? When you look deeper into this analysis, you will see that the suspension of minimum distributions at age 70½, using non-IRA funds to pay the tax on the Roth conversion, and the potential for reducing the overall combined estate and income tax will all drive your clients’ decisions.
Table 4.4, “Traditional IRA Versus Roth IRA—No Estate Tax,” shows the effect of the required minimum distribution rules that apply to a traditional IRA during a participant’s lifetime.

The Roth IRA is a superior vehicle to create wealth, because once a taxpayer reaches age 70 1/2, no minimum distributions are required. The most powerful variable you should take into account when analyzing whether to convert from a traditional IRA to a Roth IRA is whether your clients can use outside funds, that is, funds not currently invested in IRAs, to fund the income tax associated with the conversion to a Roth IRA. The mathematical advantage of rolling funds into a Roth IRA and using outside funds is quite staggering as Table 4.1 shows.

To understand the Roth IRA conversion analysis, you should reconcile the analysis of the example that follows table 4.2, in which no benefit occurred, to the analysis illustrated in table 4.4 in which an overwhelming difference is illustrated. Figure 4.1, “Total Advantage of Roth IRA Over Thirty Years,” this reconciliation, assuming an IRA balance of $500,000, an outside balance of $250,000, and growth over a thirty-year period, is as shown in the following computation.

**Table 4.4: Traditional IRA Versus Roth IRA—No Estate Tax**

<table>
<thead>
<tr>
<th>Year</th>
<th>Traditional IRA</th>
<th>Roth IRA</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Ending IRA and Outside</td>
<td>Ending IRA and Outside</td>
</tr>
<tr>
<td></td>
<td>Fund Balance</td>
<td>Taxes on IRA</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Net to Family</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Jan. 1, 2001</td>
<td>$750,000 ($140,000)</td>
<td>$610,000</td>
</tr>
<tr>
<td>Dec. 31, 2001</td>
<td>$813,847 ($148,122)</td>
<td>$665,725</td>
</tr>
<tr>
<td>Dec. 31, 2006</td>
<td>$1,217,420 ($191,889)</td>
<td>$1,025,531</td>
</tr>
<tr>
<td>Dec. 31, 2011</td>
<td>$1,802,905 ($236,404)</td>
<td>$1,566,501</td>
</tr>
<tr>
<td>Dec. 31, 2016</td>
<td>$2,643,274 ($270,944)</td>
<td>$2,372,331</td>
</tr>
<tr>
<td>Dec. 31, 2021</td>
<td>$3,841,341 ($279,199)</td>
<td>$3,562,142</td>
</tr>
<tr>
<td>Dec. 31, 2026</td>
<td>$5,551,837 ($245,502)</td>
<td>$5,306,336</td>
</tr>
<tr>
<td>Dec. 31, 2031</td>
<td>$8,023,238 ($170,197)</td>
<td>$7,853,041</td>
</tr>
</tbody>
</table>

*This assumes the Roth IRA election is made on January 1, 2001, and the entire tax liability for that year is withdrawn from the Roth IRA. It also assumes growth of 10 percent; income tax of 28 percent; and capital gain rates of 20 percent; a 100 percent turnover of outside investments; and that there is no estate tax.*
FIGURE 4.1: TOTAL ADVANTAGE OF ROTH IRA OVER THIRTY YEARS

Initial advantage based on conversion in one year,
  no tax rate differential $ 0
Advantage attributable to deferral of distributions at age 70 1/2 1,773,839
Advantage attributable to paying the tax liability with funds
  from outside of the IRA 1,165,734
Total advantage of Roth IRA over 30 years $2,939,573

The advantage is even more powerful when estate tax implications are
taken into account. See chapter 12, "Estate Planning for the Roth IRA," for a detailed discussion of the estate planning considerations.
chapter V

THE MATHEMATICS OF THE
TRADITIONAL IRA
COMPARED TO THE
NONDEDUCTIBLE IRA AND
THE ROTH IRA
The tables in this chapter show the computations of the traditional individual retirement account (IRA), the nondeductible IRA, and the Roth IRA. Interestingly, if tax rates are the same, the benefits of the Roth IRA and the deductible IRA are exactly the same after the imposition of income taxes (if the taxes come from the Roth IRA contribution). On the other hand, if the taxpayer makes a $2,000 Roth IRA contribution rather than making a $2,000 contribution to a deductible IRA and invests the tax savings in an outside account, the Roth IRA will be worth more, as shown in table 5.1, “Roth IRA Versus Traditional IRA Versus Nondeductible IRA—No Estate Tax.”

Table 5.1: Roth IRA Versus Traditional IRA Versus Nondeductible IRA—No Estate Tax

<table>
<thead>
<tr>
<th>Year</th>
<th>Age</th>
<th>Roth IRA</th>
<th>Traditional IRA</th>
<th>Nondeductible IRA</th>
<th>Taxable Account</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>30</td>
<td>$2,200</td>
<td>$2,188</td>
<td>$2,144</td>
<td>$2,156</td>
</tr>
<tr>
<td>2006</td>
<td>35</td>
<td>$16,974</td>
<td>$16,628</td>
<td>$15,582</td>
<td>$15,737</td>
</tr>
<tr>
<td>2011</td>
<td>40</td>
<td>$40,769</td>
<td>$39,295</td>
<td>$35,513</td>
<td>$35,507</td>
</tr>
<tr>
<td>2016</td>
<td>45</td>
<td>$79,089</td>
<td>$74,945</td>
<td>$65,904</td>
<td>$64,288</td>
</tr>
<tr>
<td>2021</td>
<td>50</td>
<td>$140,805</td>
<td>$131,112</td>
<td>$113,140</td>
<td>$106,187</td>
</tr>
<tr>
<td>2026</td>
<td>55</td>
<td>$240,200</td>
<td>$219,755</td>
<td>$187,504</td>
<td>$167,183</td>
</tr>
<tr>
<td>2031</td>
<td>60</td>
<td>$400,276</td>
<td>$359,872</td>
<td>$305,558</td>
<td>$255,978</td>
</tr>
<tr>
<td>2036</td>
<td>65</td>
<td>$658,079</td>
<td>$581,685</td>
<td>$493,977</td>
<td>$385,244</td>
</tr>
<tr>
<td>2041</td>
<td>70</td>
<td>$1,071,074</td>
<td>$931,129</td>
<td>$793,573</td>
<td>$571,271</td>
</tr>
</tbody>
</table>

Example: John contributes $2,000 annually to a Roth IRA, while his wife, Jane, contributes $2,560 (the $560 representing the tax savings on a $2,000 deductible contribution) annually to a deductible IRA. Jane’s cousin, Marie, contributes $2,000 annually to a nondeductible IRA. John, Jane, and Marie are age 30 and make contributions until age 70. At retirement, they remain in the 28-percent tax bracket. Jane’s outside assets are subject to a 22-percent capital-gains tax. The distributions to Jane and Marie are subject to tax at a 28-percent rate.

The same basic analysis holds true upon conversion of an IRA. If, for example, a client in a 28-percent tax bracket were to convert his or her existing $100,000 IRA to a Roth IRA, his or her income would be increased by $100,000.
Example: Jordan has $100,000 in his IRA and asks you to compare allowing his IRA to remain as a traditional IRA or converting it to a Roth IRA. Table 5.2, “Basic Roth Conversion Analysis,” shows the basic Roth conversion analysis, without taking into account the estate tax implications, or the rules concerning required minimum distributions (RMDs) that apply at age 70½.

Table 5.2: Basic Roth Conversion Analysis

<table>
<thead>
<tr>
<th></th>
<th>Traditional IRA</th>
<th>Roth IRA</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001 value</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Less tax at 28 percent</td>
<td>0</td>
<td>(28,000)</td>
</tr>
<tr>
<td>Subtotal</td>
<td>$100,000</td>
<td>$72,000</td>
</tr>
<tr>
<td>Growth over 20 years at 7 percent</td>
<td>$286,968</td>
<td>$206,617</td>
</tr>
<tr>
<td>Balance</td>
<td>$386,968</td>
<td>$278,617</td>
</tr>
<tr>
<td>Less tax at 28 percent</td>
<td>(108,351)</td>
<td>0</td>
</tr>
<tr>
<td>Net to family before taxes</td>
<td>$278,617</td>
<td>$278,617</td>
</tr>
</tbody>
</table>

Interestingly enough, these tables show that there is actually no value to using the government’s money over the twenty-year period. Mathematically, whether the asset basis is reduced by 28 percent at the front end (in the case of the Roth IRA) or later upon distributions, the result is the same. However, if the client and the planner provide foresight, they may be able to determine whether the taxpayer’s retirement income is likely to be greater or smaller than his or her current income.

Example: A young CPA or lawyer would likely benefit more from funding a Roth IRA than a deductible IRA. The deductible IRA may provide an immediate tax benefit of 15 percent or 28 percent and then be subject to a much higher rate when withdrawn. This is shown in table 5.3, “Basic Roth Conversion Analysis.”

Table 5.3: Basic Roth Conversion Analysis

<table>
<thead>
<tr>
<th></th>
<th>Traditional IRA</th>
<th>Roth IRA</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001 value</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Less tax at 28 percent</td>
<td>0</td>
<td>(28,000)</td>
</tr>
<tr>
<td>Subtotal</td>
<td>$100,000</td>
<td>$72,000</td>
</tr>
<tr>
<td>Growth over 20 years at 7 percent</td>
<td>$286,968</td>
<td>$206,617</td>
</tr>
<tr>
<td>Balance</td>
<td>$386,968</td>
<td>$278,617</td>
</tr>
<tr>
<td>Less tax at 36 percent</td>
<td>(139,308)</td>
<td>0</td>
</tr>
<tr>
<td>Net to family before taxes</td>
<td>$247,660</td>
<td>$278,617</td>
</tr>
</tbody>
</table>
Comparing the Traditional IRA, the Nondeductible IRA and the Roth IRA

In this instance, the wealth transfer is decreased by $32,000 because of the increased tax rate. For those taxpayers who are currently in a 28-percent tax bracket but expect their tax brackets to increase substantially when RMDs start, the Roth IRA may be a feasible alternative. By recognizing income today, a smaller absolute amount of taxable income is recognized, minimizing bracket creep. Additionally, the Roth IRA provides the advantage of no RMDs at age $70\frac{1}{2}$ and, as discussed later in this chapter, income from a Roth IRA will not affect taxation of the taxpayer's Social Security benefits.

Alternatively, a client in later years of employment may be in the high-earning years, earning just below the threshold for the deductible IRAs. If the client anticipates that the retirement income needed from taxable investments will be substantially less than the income in the client's highest earning years, he or she should use the traditional IRA.

Example: Lenny is currently a middle manager with a large corporation. In 2001, he expects to earn approximately $48,000. During the next ten years, he expects to retire and anticipates needing an annual income (including Social Security benefits) of approximately $25,000. For Lenny, the deductible IRA would provide a greater tax benefit by providing an immediate deduction of 28 percent and (potentially) later be subject to tax at a much lower rate.

In analyzing the Roth IRA versus the traditional IRA, you must also take into account that when a taxpayer reaches age $70\frac{1}{2}$, RMDs apply to the traditional IRA, whereas they are not required from the Roth IRA. Because of this, once a taxpayer reaches age $70\frac{1}{2}$, the Roth IRA begins to become the superior wealth-creation vehicle. Table 5.4, "Roth IRA Versus Traditional IRA Net to Family—No Estate Tax, Impact of Minimum Distribution," comparing the Roth with the traditional IRA on an after-income tax basis, shows the impact of wealth creation using a $500,000 traditional versus a $360,000 Roth IRA at age $70\frac{1}{2}$.

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2 See Internal Revenue Code (IRC) Section 408(d) for the tax treatment of distributions from a traditional IRA. See IRC Section 408A(c)(5) for the tax treatment of the Roth IRA at age $70\frac{1}{2}$. 

---
Table 5.4: Roth IRA Versus Traditional IRA Net to Family—No Estate Tax, Impact of Minimum Distribution

<table>
<thead>
<tr>
<th>Age</th>
<th>Year</th>
<th>Roth IRA</th>
<th>Traditional IRA</th>
</tr>
</thead>
<tbody>
<tr>
<td>70</td>
<td>2001</td>
<td>$396,000</td>
<td>$395,725</td>
</tr>
<tr>
<td>71</td>
<td>2002</td>
<td>$435,600</td>
<td>$434,700</td>
</tr>
<tr>
<td>72</td>
<td>2003</td>
<td>$479,160</td>
<td>$477,194</td>
</tr>
<tr>
<td>73</td>
<td>2004</td>
<td>$527,076</td>
<td>$523,499</td>
</tr>
<tr>
<td>74</td>
<td>2005</td>
<td>$579,784</td>
<td>$573,927</td>
</tr>
<tr>
<td>75</td>
<td>2006</td>
<td>$637,762</td>
<td>$628,812</td>
</tr>
<tr>
<td>76</td>
<td>2007</td>
<td>$701,538</td>
<td>$688,514</td>
</tr>
<tr>
<td>77</td>
<td>2008</td>
<td>$771,692</td>
<td>$753,416</td>
</tr>
<tr>
<td>78</td>
<td>2009</td>
<td>$848,861</td>
<td>$823,931</td>
</tr>
<tr>
<td>79</td>
<td>2010</td>
<td>$933,747</td>
<td>$900,499</td>
</tr>
<tr>
<td>80</td>
<td>2011</td>
<td>$1,027,122</td>
<td>$983,591</td>
</tr>
<tr>
<td>81</td>
<td>2012</td>
<td>$1,129,834</td>
<td>$1,073,713</td>
</tr>
<tr>
<td>82</td>
<td>2013</td>
<td>$1,242,818</td>
<td>$1,171,401</td>
</tr>
<tr>
<td>83</td>
<td>2014</td>
<td>$1,367,099</td>
<td>$1,277,237</td>
</tr>
<tr>
<td>84</td>
<td>2015</td>
<td>$1,503,809</td>
<td>$1,391,831</td>
</tr>
<tr>
<td>85</td>
<td>2016</td>
<td>$1,654,190</td>
<td>$1,515,845</td>
</tr>
</tbody>
</table>

Table 5.4 illustrates that the Roth IRA has increased to $1,654,190, whereas the funds from the traditional IRA have only grown to $1,515,845. This is because at age 70½ a taxpayer is required to begin taking distributions from his or her traditional IRA. Therefore, these distributions will be in a taxable environment (meaning, invested in bonds, stocks, or mutual funds). On the other hand, if the taxpayer does not need the funds for retirement, he or she can continue the tax-free deferral in the Roth IRA because there are no RMDs during the taxpayer’s lifetime.

Taxpayers With Nondeductible IRAs

A number of clients may have made nondeductible IRA contributions. In most instances, clients who have substantial basis in their IRAs may be wise to convert to a Roth IRA. By converting to the Roth IRA, all future growth of the IRA is not subject to income tax. If a nondeductible

---

3 Assume a beginning balance of $360,000 with no RMDs and a 10-percent growth rate.

4 Assume a $500,000 beginning balance with RMDs starting in 2001; a 10-percent growth rate, a 28-percent income tax rate on distributions, and a 22-percent tax rate on the outside account. The RMDs are taken January 1 of each year.

5 See IRC Section 408(o) for general discussion of nondeductible IRA contributions.
Comparing the Traditional IRA, the Nondeductible IRA and the Roth IRA

IRA is converted to a Roth IRA, income tax will only be paid on the fair market value in excess of basis.\(^6\)

\[ \text{Example: Dave's only IRA is valued at } 42,000, \text{ and it has a basis of } 22,000. \text{ If this IRA were converted to a Roth IRA, } 20,000 (42,000 - 22,000) \text{ of income would be recognized.} \]

Even if Dave were in a 28-percent tax bracket, the effective rate on this conversion will only be 13 percent\(^7\) because of his basis in the IRA. Again, to the extent that the account grows in the future, 100 percent of the distributions will be tax-free and at age 70\(\frac{1}{2}\), the RMD rules will not be imposed. If Dave has other IRAs, it is not clear whether the amount of income subject to tax is determined on an IRA by IRA basis or on an aggregate basis.

\[ \text{Example: Laura currently has an IRA valued at } 500,000. \text{ Her 2001 adjusted gross income (AGI) is expected to be } 85,000. \text{ She consults with you about whether to convert her existing IRA to a Roth IRA. Because of the scheduled increases in the unified credit, Laura says that she does not expect to incur an estate tax and wants your insight on this decision. She further indicates that she would like you to use a 28-percent income tax bracket for each year, ignoring the minimum distribution rules because she assumes she will be taking distributions from either IRA during the course of her retirement. Table 5.5, "A Traditional IRA Versus a Roth IRA—No Estate Tax or Required Minimum Distribution," compares the two IRAs.} \]

\(^6\) See IRC Section 408A(c)(3)(D).

\(^7\) Total tax liability of $5,600 divided by total value of $42,000 equals 13 percent.
### Table 5.5: A Traditional IRA Versus a Roth IRA—No Estate Tax or Required Minimum Distribution

<table>
<thead>
<tr>
<th>Year</th>
<th>Traditional IRA</th>
<th>Roth IRA</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Ending IRA and Outside</td>
<td>Taxes on IRA</td>
</tr>
<tr>
<td>Jan. 1, 2001</td>
<td>$750,000 (750,000)</td>
<td>($140,000)</td>
</tr>
<tr>
<td>Dec. 31, 2001</td>
<td>$820,000 (820,000)</td>
<td>($154,000)</td>
</tr>
<tr>
<td>Dec. 31, 2006</td>
<td>$1,282,499 (1,282,499)</td>
<td>($248,019)</td>
</tr>
<tr>
<td>Dec. 31, 2011</td>
<td>$2,009,468 (2,009,468)</td>
<td>($399,436)</td>
</tr>
<tr>
<td>Dec. 31, 2026</td>
<td>$7,808,177 (7,808,177)</td>
<td>($1,668,545)</td>
</tr>
<tr>
<td>Dec. 31, 2031</td>
<td>$12,314,089 (12,314,089)</td>
<td>($2,687,208)</td>
</tr>
</tbody>
</table>

*Example:* Because she is an engineer, Laura asks you to return to the first example, except she would like you to illustrate the tax being paid from outside funds. This is in addition to Laura’s IRA balance. Table 5.6, “Traditional IRA Versus Roth IRA—No Estate Tax,” illustrates this situation.

### Table 5.6: Traditional IRA Versus Roth IRA—No Estate Tax

<table>
<thead>
<tr>
<th>Year</th>
<th>Traditional IRA</th>
<th>Roth IRA</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Ending IRA and Outside</td>
<td>Taxes on IRA</td>
</tr>
<tr>
<td>Jan. 1, 2001</td>
<td>$750,000 (750,000)</td>
<td>($140,000)</td>
</tr>
<tr>
<td>Dec. 31, 2001</td>
<td>$820,000 (820,000)</td>
<td>($154,000)</td>
</tr>
<tr>
<td>Dec. 31, 2006</td>
<td>$1,282,499 (1,282,499)</td>
<td>($248,019)</td>
</tr>
<tr>
<td>Dec. 31, 2011</td>
<td>$2,009,468 (2,009,468)</td>
<td>($399,436)</td>
</tr>
<tr>
<td>Dec. 31, 2026</td>
<td>$7,808,177 (7,808,177)</td>
<td>($1,668,545)</td>
</tr>
<tr>
<td>Dec. 31, 2031</td>
<td>$12,314,089 (12,314,089)</td>
<td>($2,687,208)</td>
</tr>
</tbody>
</table>

---

8 This assumes the Roth IRA election is made on January 1, 2001, and the entire tax liability for that year is withdrawn from the Roth IRA. It also assumes growth of 10 percent; income tax of 28 percent; capital gain rates of 20 percent; and no estate tax or RMD.

9 Assumes a 2000 ending IRA balance of $500,000 and an outside balance of $250,000.

10 This assumes the Roth IRA election is made on January 1, 2001, and the entire tax liability for that year is withdrawn from the Roth IRA. It also assumes growth of 10 percent; income tax of 28 percent; and capital gain rates of 20 percent; and that there is no estate tax.
Comparing the Traditional IRA, the Nondeductible IRA and the Roth IRA

Example: Same as the previous example, except that Laura has asked you to determine the impact of the RMD rules on your analysis. Table 5.7, “Traditional IRA Versus Roth IRA—No Estate Tax, Income Tax Paid With Outside Funds,” illustrates this example.

Table 5.7: Traditional IRA Versus Roth IRA—No Estate Tax, Income Tax Paid With Outside Funds

<table>
<thead>
<tr>
<th>Year</th>
<th>Traditional IRA</th>
<th>Roth IRA</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Ending IRA and Outside Fund Balance</td>
<td>Taxes on IRA</td>
</tr>
<tr>
<td>Jan. 1, 2001</td>
<td>$750,000</td>
<td>($140,000)</td>
</tr>
<tr>
<td>Dec. 31, 2001</td>
<td>$813,847</td>
<td>($148,112)</td>
</tr>
<tr>
<td>Dec. 31, 2006</td>
<td>$1,217,420</td>
<td>($191,889)</td>
</tr>
<tr>
<td>Dec. 31, 2011</td>
<td>$1,802,905</td>
<td>($236,404)</td>
</tr>
<tr>
<td>Dec. 31, 2016</td>
<td>$2,643,274</td>
<td>($270,944)</td>
</tr>
<tr>
<td>Dec. 31, 2021</td>
<td>$3,841,341</td>
<td>($279,199)</td>
</tr>
<tr>
<td>Dec. 31, 2026</td>
<td>$5,551,837</td>
<td>($245,502)</td>
</tr>
<tr>
<td>Dec. 31, 2031</td>
<td>$8,023,238</td>
<td>($170,197)</td>
</tr>
</tbody>
</table>

Moreover, the following computation shows the total advantage of the Roth IRA over thirty years.

Initial advantage based on conversion, no tax rate differential $0
Advantage attributable to deferral of distributions at age 70 1,773,840
Advantage attributable to paying funds from outside of the IRA 1,165,734
Total advantage of Roth IRA over thirty years $2,939,574

When a client does not expect to be subject to estate tax, the analysis of whether to convert from a traditional IRA to a Roth IRA turns on the following factors:

- Any changes in marginal income tax rates
- Whether taxes generated by the conversion can be funded from a source outside of the traditional IRA
- The benefit of avoiding RMD rules applicable at age 70 1/2
- The impact on the taxation of Social Security benefits

11 This assumes the Roth IRA election is made on January 1, 2001, and the entire tax liability for that year is funded from assets outside the IRA. It also assumes growth of 10 percent; income tax of 28 percent; capital gain rates of 20 percent; and that there is no estate tax.
A further consideration is the investment portfolio design the taxpayer is using. See chapter 7, “Portfolio Management Considerations,” for a detailed discussion of portfolio considerations.

**TAXATION OF SOCIAL SECURITY BENEFITS**

Many taxpayers need to take into account how the Roth IRA conversion election affects the taxation of their Social Security benefits. See chapter 8, “The Roth IRA and Your Client’s Retirement,” for an explanation of the impact of an IRA conversion on the taxation of Social Security benefits.

**THE IMPACT OF FUTURE ESTATE TAX ON THE CONVERSION DECISION**

**Example:** John has a $3 million stock portfolio in addition to his $1 million IRA. Assume that at the time of his death, his IRA will be exposed to a 55-percent estate tax (including an 8-percent state estate tax).

**Table 5.8: IRC Section 691(c) Deduction Compared to Paying Income Tax**

<table>
<thead>
<tr>
<th></th>
<th>Estate Tax First Traditional IRA</th>
<th>Income Tax First Roth IRA</th>
</tr>
</thead>
<tbody>
<tr>
<td>IRA balance</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Less income tax</td>
<td>0</td>
<td>(396,000)</td>
</tr>
<tr>
<td>Less federal estate tax</td>
<td>(470,000)</td>
<td>0</td>
</tr>
<tr>
<td>Less state estate tax</td>
<td>(80,000)</td>
<td>0</td>
</tr>
<tr>
<td>Total taxes</td>
<td>(550,000)</td>
<td>(396,000)</td>
</tr>
<tr>
<td>Net to family</td>
<td>$ 450,000</td>
<td>$ 604,000</td>
</tr>
<tr>
<td>Less estate tax</td>
<td></td>
<td>(332,200)</td>
</tr>
<tr>
<td>IRA balance subject to income tax</td>
<td>$1,000,000</td>
<td></td>
</tr>
<tr>
<td>Less IRC Sec. 691(c) deduction</td>
<td>(470,000)</td>
<td></td>
</tr>
<tr>
<td>Balance subject to income tax</td>
<td>530,000</td>
<td></td>
</tr>
<tr>
<td>Less income tax at 39.1 percent</td>
<td>(207,230)</td>
<td></td>
</tr>
<tr>
<td>Net to family</td>
<td>$ 242,770</td>
<td>$ 271,800</td>
</tr>
</tbody>
</table>

In John’s case, his wealth transfer is enhanced by paying the income tax before paying the estate tax. See table 5.8, “IRC Section 691(c) Deduction Compared to Paying Income Tax First.” This occurs because the IRC Section 691(c), income in respect of a decedent deduction allows only for
the deduction of federal estate tax. (The state estate tax is not deductible in determining federal taxable income.)

To further complicate these computations, the IRC Section 691(c) deduction for estate tax paid is subject to the 3-percent adjustment to itemized deductions. This limitation will generally make the Roth IRA even more desirable. The following illustrates this limitation.

**Example:** Mary is the beneficiary of her deceased father’s IRA. The 691(c) deduction for the current year is $5,000. In addition, Mary’s and her spouse’s AGI for the year is $200,000. Because their combined AGI is greater than $132,950 (itemized deduction phaseout limit for 2001), $2,012 \([($200,000\text{ AGI} - $132,950\text{ itemized deduction limit}) \times 3\%]\) of their itemized deductions will be phased out. The effect of this is that Mary’s $5,000 691(c) deduction is not fully utilized.

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12 IRC Section 68(a).
The Roth IRA and the Younger Taxpayer

Chapter VI
Younger clients may ask, "Why should I contribute to a Roth IRA?" The Roth individual retirement account (IRA) is superior to the traditional IRA in the following two respects.

1. Once contributed, 100 percent of the growth on the Roth IRA is tax-free.
2. It is easier to access funds in a Roth IRA before age 59 1/2 than a regular IRA.

Internal Revenue Code (IRC) Section 408A(d)(1)(B) provides that distributions from a Roth IRA are first treated as made from contributions. Because distributed contributions are a nontaxable return of principal, they are not subject to either income tax or the excise tax imposed under IRC Section 72(t).

Why Would a Younger Taxpayer Contribute to a Roth IRA?

Although contributions are not deductible, the Roth IRA allows a taxpayer to maximize his or her distribution stretch because distributions are not required at age 70 1/2. This feature is further enhanced because there is no prohibition on making contributions after attaining age 70 1/2.

Additionally, qualified distributions from the IRA are not taxable, and earnings on the account are taxable only when nonqualified distributions are made. These features maximize a taxpayer's ability to achieve the deferral of tax and accumulate significant retirement wealth on a tax-free basis for the benefit of future generations.

Income Limitations on Contributions

Annual contribution limitations to Roth IRAs have been increased under the Economic Growth and Reconciliation Act of 2001 (the 2001 Act). For years 2002 through 2004, the deductible limit is $3,000; for years 2005 through 2007, the limit will be $4,000; and for years 2008 and beyond, the limit will be $5,000. For tax years beginning after 2008, the $5,000 contribution limit is adjusted to reflect cost-of-living increases.

Contributions are reduced by any other traditional IRA contributions (except for educational IRA contributions). The contribution limit is
phased out as the taxpayer's AGI increases from $150,000 to $160,000\(^1\) for joint filers and $95,000 to $110,000\(^2\) for a single taxpayer.

Individuals who are 50 years or older before the end of the tax year are allowed a catch-up contribution amount. For years 2002 through 2005, this amount is $500 and for years 2006 and beyond, the amount is $1,000. The additional amount is added to the regular deductible limit to make limits for those 50 and older as follows. See table 6.1, "Catch-Up Contribution Amounts."

**TABLE 6.1: CATCH-UP CONTRIBUTION AMOUNTS**

<table>
<thead>
<tr>
<th>Taxable Years</th>
<th>Deductible Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002 through 2004</td>
<td>$3,500</td>
</tr>
<tr>
<td>2005</td>
<td>$4,500</td>
</tr>
<tr>
<td>2006 and 2007</td>
<td>$5,000</td>
</tr>
<tr>
<td>2008 and beyond</td>
<td>$6,000</td>
</tr>
</tbody>
</table>

Married taxpayers with AGI over $160,000 and single taxpayers with AGI over $110,000 cannot contribute to a Roth IRA. These taxpayers, however, may still contribute to a nondeductible IRA. Furthermore, in certain instances, proper tax planning may allow a taxpayer to reduce his or her income below $150,000 in a particular year to qualify for the Roth IRA.

**Example:** In 2002, John and Betty each earn $60,000. In addition, they have interest and dividend income of about $30,000 to $40,000 per year. With proper planning, John and Betty may be able to reduce their AGI to under $150,000, thereby allowing $6,000 of contributions to Roth IRAs.

**Withdrawals from the Roth IRA**

Any qualified distribution from a Roth IRA is not includible in gross income. Qualified distributions include the following:

- Distributions made after the taxpayer attains age 59\(\frac{1}{2}\)
- Distributions to a beneficiary after the taxpayer's death
- Distributions attributable to disability of the taxpayer

\(^1\) IRC Section 408A(c)(3)(C)(ii)(I).
\(^2\) IRC Section 408A(c)(3)(C)(ii)(II).
A qualified special-purpose distribution (a distribution for first-time home buyers)

However, no payment can be a qualified distribution unless it is made after the five-year taxable period beginning with the first taxable year in which a contribution was made to a Roth IRA.  

Early withdrawals from the Roth IRA (before 591/2) are permitted, on a tax-free basis, as long as the taxpayer is withdrawing contributions, not accumulated earnings. Thus, taxpayers can first withdraw their original contributions to the Roth IRA. Unlike the traditional IRA with nondeductible contributions that follow the annuity rules, the Roth IRA has a special set of rules providing that all distributions first come from nondeductible contributions. Therefore, with a contributory Roth IRA, a taxpayer can get the basis out even within the first five years.

Example: For the last 15 years, Bob, age 45, has been contributing $3,000 annually to his Roth IRA. His basis in the IRA is $45,000 and it has a current market value of $75,000. If Bob makes a $45,000 withdrawal from his Roth IRA, it would be a nontaxable withdrawal that avoids the imposition of the 10-percent excise tax.

Example: The same as the preceding example, except that Bob withdraws $55,000 from his Roth IRA. Although $45,000 is still treated as a tax-free return of the original contribution, the remaining $10,000 is a nonqualified distribution that is subject to both income and excise tax.

The Benefit of Creating a Roth IRA Compared With a Traditional IRA or Nonqualified Account

Example: Jessica, who is in the 28-percent tax bracket, has the option of creating a Roth IRA, a traditional IRA, or a nonqualified retirement account. She will contribute $2,000 annually for thirty years to the Roth IRA or a taxable account, or $2,560 (reflecting the $560 tax savings) to a traditional IRA. The investments are projected to grow at an annual 10-percent rate. If any capital gains are realized in the nonqualified account and traditional IRA, they will be taxed at a 22-percent rate. The required minimum distributions from the traditional IRA start when Jessica is age 70 (in 2051). Table 6.2, "Comparison of Roth IRA, Traditional IRA, and

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3 IRC Section 408A(d)(2)(B)(f).
Nonqualified Account—Net to Family, No Estate Tax,” shows the comparison.

Table 6.2: Comparison of Roth IRA, Traditional IRA, and Nonqualified Account—Net to Family, No Estate Tax

<table>
<thead>
<tr>
<th>Year</th>
<th>Roth IRA</th>
<th>Traditional IRA</th>
<th>Taxable Account</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>$2,200</td>
<td>$2,188</td>
<td>$2,156</td>
</tr>
<tr>
<td>2006</td>
<td>$16,974</td>
<td>$16,628</td>
<td>$15,737</td>
</tr>
<tr>
<td>2011</td>
<td>$40,769</td>
<td>$39,295</td>
<td>$35,507</td>
</tr>
<tr>
<td>2016</td>
<td>$79,089</td>
<td>$74,945</td>
<td>$64,288</td>
</tr>
<tr>
<td>2021</td>
<td>$140,805</td>
<td>$131,112</td>
<td>$106,187</td>
</tr>
<tr>
<td>2026</td>
<td>$240,200</td>
<td>$219,755</td>
<td>$167,183</td>
</tr>
<tr>
<td>2031</td>
<td>$398,076</td>
<td>$357,406</td>
<td>$253,822</td>
</tr>
<tr>
<td>2036</td>
<td>$641,105</td>
<td>$555,954</td>
<td>$369,508</td>
</tr>
<tr>
<td>2041</td>
<td>$1,032,505</td>
<td>$849,423</td>
<td>$537,920</td>
</tr>
<tr>
<td>2046</td>
<td>$1,662,860</td>
<td>$1,273,197</td>
<td>$783,089</td>
</tr>
<tr>
<td>2051</td>
<td>$2,678,053</td>
<td>$1,868,261</td>
<td>$1,140,000</td>
</tr>
</tbody>
</table>

The Benefit of a Roth IRA Compared to a 401(k) Plan

If a client’s funds are limited so that he or she cannot participate in both a Roth IRA and a 401(k) plan, a decision must be made about which savings plan is more advantageous. In general, during a taxpayer’s earning years, it may be more feasible to contribute to a 401(k) plan than to a Roth IRA. Remember, mathematically, a Roth IRA has no significant benefit over a 401(k) plan in that the benefit is derived from tax deferral, not from the tax-free treatment of the withdrawals. Whether the tax is paid at the front end (in the case of a Roth IRA) or later, on withdrawals [in the case of a 401(k)], the result is the same if the rates of return on investment and the tax rates remain the same. If a taxpayer expects his or her tax bracket to increase over time, the Roth IRA may provide a significant benefit. Alternatively, if a taxpayer is currently taking a 401(k) deduction in a high-tax year (in the years before retirement), the 401(k) plan is more attractive than the Roth IRA.

In addition, many 401(k) plans also provide for employer provided matching benefits. Obviously, when a taxpayer receives a matching benefit, the 401(k) plan (at least to the extent of the match) is a more attractive vehicle than the Roth IRA. One possible advantage of the Roth IRA compared with the 401(k) plan is that early withdrawals may be taken from the Roth IRA.
to the extent they do not exceed the taxpayer's basis.\footnote{IRC Section 408A(d)(1)(B) provides that distributions shall first be considered to come from basis before being considered from income.} Another advantage of a 401(k) plan is the creditor protection provided under the rule of the Employment Retirement Income Security Act of 1974 (ERISA) rules. IRA creditor protection is provided by state law that, in addition to varying from state to state, might be less than the protection afforded by ERISA.

Many taxpayers accumulate substantial wealth within 401(k) plans. The Roth IRA provides them with the advantage of no required minimum distribution at their required beginning date, allowing them to reduce future taxes.
PORTFOLIO MANAGEMENT

CONSIDERATIONS

chapter VII
A key consideration in portfolio design is which portion of the investment pyramid (from the riskiest at the pinnacle to the safest at the base) should be invested within the qualified retirement plan, individual retirement account (IRA), or Roth IRA, and which portion belongs outside of the qualified plan, IRA, or both. A secondary consideration is positioning the client’s portfolio to reduce income to below $100,000, thereby allowing for the conversion of a traditional IRA to a Roth IRA. Your clients may ask you about which asset classifications they should acquire for which retirement portfolio. For example, the questions may be, “Should my aggressive commitments be placed in my 401(k) plan, my traditional IRA, my Roth IRA, or positioned outside of my qualified plans?” These could be difficult questions for you and for the client’s investment advisers.

### Advantages of Investments Within the Qualified Plan, Traditional IRA or Roth IRA

The advantages of investing through qualified plans include the following.

- Growth and earnings are tax-deferred.
- An income tax advantage is often available when the plan or IRA is established.
- Tax rates may decrease before distributions.
- There are certain favorable tax treatments for distributions, for instance, Internal Revenue Code (IRC) Section 408 rollovers, and forward averaging.
- Qualified plan assets may also be afforded additional protection in bankruptcy.

### Advantages of a Roth IRA

The advantages of investing through a Roth IRA include the following.

- Qualified distributions are tax-free.
- Contributions can be withdrawn on a tax-free, first-in, first-out (FIFO) basis.
- Roth IRA distributions are not considered income for determining whether Social Security benefits are taxable.
DISADVANTAGES OF INVESTMENTS WITHIN A QUALIFIED PLAN OR IRA

The disadvantages of investing through a qualified plan or IRA include the following.

■ There is no step-up in basis on death.
■ Tax rates may increase before distributions.

DISADVANTAGES OF A ROTH IRA

The disadvantages of investing through a Roth IRA include the following.

■ There is no up-front deduction.
■ Income is recognized on conversion of a traditional IRA to a Roth IRA.
■ Income recognized on conversion may affect the taxation of Social Security benefits.

OVERALL PORTFOLIO THEORY

When planning a client’s investment portfolio, all investments, including any qualified plan or IRA investments and investments outside of such plans should be managed as one portfolio from an investment and tax perspective. In essence, this means looking at proper asset allocation and tax strategies, and other investment considerations on a comprehensive basis rather than subportfolio by subportfolio basis.

Although much of the tax and financial theory underlying the overall portfolio theory is well settled, the Economic Growth and Tax Relief Reconciliation Act of 2001 (the 2001 Act) may add some additional complexity to a client’s investment planning. In particular, when putting portfolio theory to work for a client, you should keep the following in mind.

■ Qualified distributions from a Roth IRA are not subject to income tax.
■ The maximum federal tax rate for individuals is 39.1 (in 2001) percent compared with a 20-percent capital gains rate.
For married individuals with incomes of greater than $166,500, a tax rate of 35.5 (in 2001) percent exists.

A portion of many clients' Social Security benefits are subject to federal income tax, as follows.

- Married clients earning more than $32,000 (for single clients, the threshold is $25,000) will pay tax on 50 percent of their Social Security benefits (IRC Section 86).
- Married clients earning more than $44,000 (for single clients, the threshold is $34,000) will pay tax on 85 percent of their Social Security benefits.

INVESTMENT ALLOCATION

A client should consider dividing his or her investment securities between qualified plans and nonqualified plans. To the extent that the client has a security that appreciates in value, the step-up in basis and capital gains rates are available. Alternatively, if a security goes down in value, capital losses are available. In the context of a qualified plan or IRA, securities that appreciate substantially can be sold on a tax-free basis and repositioned within other investments. Further, the tax rate differential between ordinary income and capital gains could make holding growth equities outside of a qualified plan more attractive.

For many clients, placing a portion, for example, 40 percent, of their investment in an investment account and putting the remaining 60 percent in an IRA or qualified plan may be appropriate. If the plan appreciates in value, the securities within the IRA can be sold on a tax-free basis, without tax erosion.

Municipal Bonds

Because municipal bonds are not subject to federal income tax, these investments are inappropriate for a traditional IRA or Roth IRA.

U.S. Government Securities

Because of the conservative nature of U.S. government securities, they may well be appropriate for investment in an IRA. Further, under the tax law of many states, IRA distributions, to the extent that earnings represent income from U.S. government securities, are not subject to tax.
Corporate Bonds

Corporate bonds may also be an appropriate investment for an IRA in that the earnings from the bonds are free of income tax until distribution from the IRA.

High Yield Equities

High-yield equities may be an appropriate investment for an IRA or Roth IRA, because the earnings from the equities are free of income tax until distribution.

Growth Equities

Although generally appropriate for an IRA investment, certain blue chip investments that are considered to be hold investments may be best suited for investing outside of an IRA. The reason for this is the step-up in basis available at death and the applicable capital gains rate. The taxpayer should consider dividing hold investments between qualified and nonqualified funds.

Speculative Equities

Although often appropriate for an IRA, speculative investments, by their very nature, result in more losses (in addition to more gains), and holding these investments so the losses can be used to offset other capital gains may be appropriate. Further, balancing speculative investments in a particular issue between individual investments and IRA investments may be appropriate. In this regard, when certain growth objectives are obtained, the stock either outside the IRA or inside the IRA can be sold leaving the other assets in the portfolio.

It is also important to consider your client’s years remaining to retirement when including speculative investments in a portfolio. By their nature, speculative investments might not be ripe for liquidation when needed to generate retirement cash flow. Thus, the closer your client is to retirement, the less attractive speculative investments become regardless of whether they are in an IRA or held directly by the client.

Real Estate

Nonleveraged real estate is an acceptable investment for an IRA, and the income will be sheltered from tax in future years. Leveraged real estate
PORTFOLIO MANAGEMENT CONSIDERATIONS

may be more appropriately positioned outside a client’s IRA, because losses (subject to the passive loss rules under IRC Section 469) are tax-deductible. Further, with older clients, a step-up in basis or death may be a related estate planning consideration.

Low-income housing credit partnerships (under IRC Section 42) are more appropriately held outside of an IRA. These credits are of no benefit when held within an IRA.

Options

Covered-call writing is allowed under the rules governing IRAs. Generally, other option positions, however, will have to be used outside the IRA.

BLENDING THEORY WITH PRACTICE

Overall portfolio theory provides some good guidelines for investment advisers. Therefore, unless you fill that role, you should work closely with your client’s investment advisers. It is very important that you understand your client’s financial objectives and the nature of the underlying investments. Communication among members of the client’s planning team is critical.

Two of the key guidelines in evaluating the overall portfolio theory are the age and health of the client and spouse. If a client’s death, and therefore a step-up in basis, is foreseeable in the near future (for example, advanced age or severe illness), you should consider holding a larger portion of the growth portfolio outside of any IRA, while keeping more of the conservative assets within a traditional IRA.

When choosing the investments for traditional and Roth IRAs, you should consider holding high-growth assets in the Roth IRA, while assets with lower growth potential should be held in the traditional IRA. Although neither IRA pays tax on current earnings or growth, the lack of a withdrawal tax for the Roth IRA would minimize the tax erosion on the part of the portfolio that experienced the better return.

For newly retired clients for whom a portion of their Social Security benefits are subject to federal income tax, you should consider holding foundation investments (for example, bonds) in an IRA, especially if distributions are not required, while holding the growth portfolio outside of the IRA.
For clients in community-property states, at the death of the first spouse, a complete step-up in basis occurs on the property held outside of an IRA. This is an important factor to consider when determining which assets should be held within a qualified environment, versus outside of the qualified environment.

Portfolio theory also becomes important for clients leaving a retirement plan. Many clients have a substantial portion of their portfolio in the stock of their employer. Allowing this stock which has been held in a qualified plan for many years to move into a safer portfolio is a difficult decision for the clients. As a possible solution, it may be appropriate to sell the stock over a period of time, using hedging strategies (generally outside of the IRA) to assure that value is preserved. It may also be possible to reposition the portfolio by reinvesting dividends in other stocks and market sectors.
The Roth IRA and Your Client's Retirement

Chapter VIII
At retirement, your clients will ask you a number of questions about the Roth individual retirement account (IRA), including the following.

- I am 56 years old. When can I take distributions from the Roth IRA?
- Should I convert my existing traditional IRA to a Roth IRA?
- Should I pay the taxes on the Roth IRA conversion from my Roth IRA or other assets?
- Should I borrow to pay taxes on the Roth IRA conversion?
- Should I transfer my current qualified plan to a traditional IRA and subsequently make a Roth IRA election?
- Should I roll out employer stock (qualified employer securities) while rolling out a portion of the plan to a regular IRA and subsequently to a Roth IRA?

### Retirement Before Age 59½

At retirement, before age 59½, clients often ask, “From which portfolio should I take my retirement income?” One step is to develop a cash-flow plan that is designed to avoid the Internal Revenue Code (IRC) Section 72(t) 10 percent penalty. The exceptions to the 10-percent penalty tax, which apply to both traditional and Roth IRAs, are as follows:

- Payments on account of the participant’s death
- Payments on account of the participant’s disability
- One of a series of substantially equal periodic payments (SEPP)
- Payments on account of a separation from service after age 55, which does not apply to early distributions from IRAs
- Dividends with respect to qualifying employer securities
- Distributions to an alternate payee pursuant to a qualified domestic relations order (QDRO), which does not apply to early distributions from Roth IRAs or traditional IRAs
- Amounts not in excess of allowable medical expense deduction
- Specified insurance premium payments (This exception cannot apply to early distributions from IRAs, because IRAs cannot hold life insurance, nor can they receive a rollover of the insurance premium payments from a qualified plan.)
Excess deferrals, excess contributions, and excess aggregate contributions

Amounts rolled over into an IRA, because the amounts are not included in income

Nontaxable portion equal to return of participant’s investment (employee contributions or insurance premium payments)

Distributions to unemployed individuals for health insurance premiums

Qualified higher education expenses

Qualified first time home-buyer expenses

Roth IRA conversions

When a taxpayer desires to take funds from a Roth IRA for a nonqualified purpose before age 59½, he or she is subject to regular income tax. However, to the extent the distribution represents a return of original contribution (or income realized upon conversion) the distribution is not taxable and not subject to the special 10-percent penalty tax.¹

Example: Rich, age 30, saves $2,000 annually for 25 years in a Roth IRA. At age 55, Rich has a balance of $216,364. If Rich began taking SEPP, the results shown in table 8.1, “Tax Consequences of Substantially Equal Periodic Payments,” occur.

**Table 8.1: Tax Consequences of Substantially Equal Periodic Payments**

<table>
<thead>
<tr>
<th>Age</th>
<th>SEPP²</th>
<th>Cumulative Basis</th>
<th>Recovery of Basis</th>
<th>Nontaxable Qualified Distribution</th>
<th>Taxable Nonqualified Distribution³</th>
<th>10% Early Distributions Penalty</th>
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</thead>
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<td>$50,000</td>
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<tr>
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<td>$0</td>
<td>$17,089</td>
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<td>$0</td>
<td>$22,363</td>
<td>$0</td>
</tr>
</tbody>
</table>

¹ IRC Section 408A(d)(1)(B) provides that distributions shall be treated as coming first from basis and second from earnings.

² Assumes 120 percent of the annual long-term applicable federal rate is 8 percent. The annuity method for calculating the payment is used.

³ The amount of the nonqualified distribution is subject to both income tax and the 10-percent excise tax for early withdrawals.
Example: Lee, age 45, saves $2,000 annually in a Roth IRA. At age 55, the balance is $35,062. If Lee began taking SEPP, the following results shown in table 8.2, “Tax Consequences of Substantially Equal Periodic Payments,” occur.

### Table 8.2: Tax Consequences of Substantially Equal Periodic Payments

<table>
<thead>
<tr>
<th>Age</th>
<th>SEPP1</th>
<th>Cumulative Basis</th>
<th>Recovery of Basis</th>
<th>Nontaxable Qualified Distribution</th>
<th>Taxable Nonqualified Distribution</th>
<th>10% Early Distribution Penalty</th>
</tr>
</thead>
<tbody>
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<td>$20,000</td>
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<td>$12,752</td>
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<tr>
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<td>$9,128</td>
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<tr>
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<td>$5,504</td>
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<td>$0</td>
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</tr>
<tr>
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<td>$3,624</td>
<td>$1,880</td>
<td>$1,880</td>
<td>$0</td>
<td>$1,744</td>
<td>$0</td>
</tr>
</tbody>
</table>

### Taxation of Social Security Benefits

Many clients need to take into account how the Roth IRA conversion election affects the taxation of their Social Security benefits. Current law provides that when a single individual’s income, which is the individual’s adjusted gross income (AGI) plus one-half of Social Security benefits, exceeds $25,000 and a married couple’s income exceeds $32,000, up to 50 percent of the Social Security benefits is subject to income tax. To further complicate matters, a second formula taxing 85 percent of the Social Security benefits must also be taken into account. This formula provides that Social Security benefits are taxed when a single individual’s income (modified AGI plus one-half of the Social Security benefits) exceeds $34,000 and a married couple’s income exceeds $44,000. If a married couple makes a Roth IRA election, they will have phantom income. This phantom income, when added to their regular income, may increase total AGI over $44,000. When this occurs, their Social Security income becomes subject to income tax.

Example: Joe and Amanda receive $20,000 of interest and dividend income in 2002 and $24,000 in Social Security benefits. In addition, they choose to rollover $100,000 from a traditional IRA to a Roth IRA for

---

1 Assumes 120 percent of the annual long-term applicable federal rate is 8 percent. The annuity method for calculating the payment is used.
each of the next four years. Under this scenario, their AGI before their Social Security benefits is now $45,000 [$20,000 + ($100,000 + 4)]. In this case, a portion of their Social Security benefits becomes subject to taxation. Alternatively, if the couple waits until 2003, 100 percent of the income created by converting the traditional IRA to the Roth IRA is subject to income tax in 2003. This may actually have a more favorable result than the previous situation, in which the Roth IRA conversion creates significant phantom income in each year, causing Social Security to become subject to income tax for each of four years. As a practical matter, when you provide advice to clients whose Social Security income is not currently subject to tax, you should try to make sure that income associated with the Roth IRA conversion does not inadvertently subject Social Security benefits to income tax. There may be instances in which this is acceptable. However, for most clients, if $10,000 to $15,000 of Social Security income suddenly becomes subject to income tax, the cost of the Roth IRA conversion may be too high.

Example: Julie is age 70 and has taken her IRA distributions since retirement. Her IRA is valued at $250,000. In 2002, her required minimum distribution will make 85 percent of her Social Security benefits subject to income tax. By converting her IRA to a Roth IRA, her Social Security income continues to be taxed for the first four years and is not subject to tax after that. Thus, by converting what would be ordinary IRA income into Roth IRA income, it may be possible to avoid taxation of Social Security benefits.

Because Roth IRA income is not part of the Social Security inclusion formula, many taxpayers planning retirement may desire to convert to a Roth IRA.

Rollover of Qualified Plan Balance

There is nothing in the language of the Act or the related committee reports indicating that a taxpayer cannot transfer funds from a qualified plan to a traditional IRA and subsequently make a Roth IRA election.

Example: Andrew is a salesman for a major corporation and has $1 million in his pension plan. At retirement, he chooses to transfer (in a trustee-to-trustee transaction) the entire $1 million into an IRA and subsequently divide the IRA into several traditional IRAs. Once the traditional IRAs are established, nothing is in the statute to prevent
Andrew from converting either one or all of the traditional IRAs to Roth IRAs.
The conversion would most likely occur in the year following retirement when Andrew’s AGI is below $100,000. If the conversion occurs after 1998, 100 percent of the income is realized in the year of conversion.

CONTRIBUTIONS AFTER RETIREMENT

Beginning in 1998, a retired client with wage income or other self-employment income is able to make a contribution to a Roth IRA equal to the lesser of $2,000 or 100 percent of the client’s annual compensation less any amounts contributed to a traditional IRA during the year. The income limitation of $150,000 for married couples and $95,000 for individual taxpayers continues to exist. If a client after formal retirement continues to earn compensation, the client has tremendous incentive to continue to make contributions to a Roth IRA. In fact, there may be instances in which the client is withdrawing funds from a regular IRA and still contributing to a Roth IRA.

IRA DISTRIBUTIONS

At retirement many clients ask their planners, “Should I take funds from my regular IRA or my Roth IRA first?” This is apparently both an annual income tax planning question and an estate planning question. General rules for the taxpayer are the following.

■ Retain funds in the Roth IRA while taking distributions from the traditional IRA.
■ Avoid nonqualified (taxable) Roth IRA distributions.
■ Monitor taxation of Social Security benefits.
■ “Rebalance” one’s portfolio to properly position assets in the Roth and traditional IRAs.

5 IRC Section 408A(c)(3)(C).
TAXPAYERS AT THEIR
REQUIRED BEGINNING DATE

chapter IX
Required minimum distributions (RMDs) from a traditional individual retirement account (IRA) must begin on or before April 1 of the year following the year in which a client turns age 70\(\frac{1}{2}\) (generally known as one's required beginning date).\(^1\) The Roth IRA, however, is not subject to these rules. It seems logical that a taxpayer, to the extent he or she does not need the cash flow, would want to retain funds within the Roth IRA, allowing the funds to continue to grow tax-free.

### Lifetime Distributions: Traditional IRAs

Lifetime distribution calculations have been greatly simplified by the new proposed regulations. We now need to reference only one table when making such calculations; see table 9.1, "Determining Factor Lifetime Distributions." There is no longer a need to elect recalculation versus

#### Table 9.1: Determining Factor Lifetime Distributions

<table>
<thead>
<tr>
<th>Attained Age in Year of Distribution</th>
<th>Applicable Divisor Under New Regulations</th>
<th>Attained Age in Year of Distribution</th>
<th>Applicable Divisor Under New Regulations</th>
</tr>
</thead>
<tbody>
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</tr>
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</tr>
<tr>
<td>80</td>
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<td>104</td>
<td>4.4</td>
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<td>16</td>
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<td>92</td>
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<td>115 and older</td>
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</tbody>
</table>

\(^1\) Internal Revenue Code (IRC) Section 401(a)(9)(A).
nonrecalculation of life expectancy nor is the age of the beneficiary taken into account.²

As can be seen in the table 9.2, “Calculating Lifetime Required Minimum Distributions,” the new distributions factors provide a tremendous advantage over the old regulations.

**Table 9.2: Calculating Lifetime Required Minimum Distributions**

<table>
<thead>
<tr>
<th>Age</th>
<th>Distribution Factor for New Regulations</th>
<th>Distribution Factor Under Old Double Recalculation</th>
<th>Additional Required Distribution Under Old Rule (Stated as a Percentage)</th>
<th>Old Double Term Certain</th>
<th>Additional Required Distribution Under Old Rule (Stated as a Percentage)</th>
<th>Old Hybrid IRA owner, Do Not Recalculate (Stated as a Percentage)</th>
<th>Additional Required Distribution Under Old Rule (Stated as a Percentage)</th>
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<td>35.21%</td>
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<td>12.7</td>
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<td>10.1</td>
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<td>1650.00%</td>
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<td>77.46%</td>
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</table>

Under the old regulations, one's required beginning date provided a deadline by which a designated beneficiary's life expectancy was "locked in" for purposes of not only lifetime distributions, but also post-death distributions. The owner could always change a beneficiary, but not so as to extend life expectancy. Under the new proposed regulations, the determination of beneficiary for purposes of determining post-death distributions is not made until December 31 of the year following the year of death.

The majority of post-death distributions are based on the ordinary life annuity table of Treas. Reg. Sec. 1.72-9 and reduced by one for each year.

²The age of the beneficiary is taken into account, however, if the beneficiary is a spouse who is ten years younger than the owner. The joint life expectancy of the owner and spouse may then be used to calculate required minimum distributions (RMDs).
after the year of death which is reproduced in table 9.3, “Treas. Reg. Sec. 1.72-9—Ordinary Life Annuities One Life Expected Return Multiples.”

By forestalling the post-death determination of the designated beneficiary until this time, the named primary beneficiary may execute a disclaimer or partial disclaimer and thereby change the beneficiary and most importantly, the measuring life expectancy.

### Table 9.3: Treas. Reg. Sec. 1.72-9—Ordinary Life Annuities One Life Expected Return Multiples

<table>
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<th>Age</th>
<th>Multiple</th>
<th>Age</th>
<th>Multiple</th>
<th>Age</th>
<th>Multiple</th>
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<td>1.9</td>
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<td>17.6</td>
<td>105</td>
<td>1.8</td>
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<td>106</td>
<td>1.6</td>
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<td>108</td>
<td>1.3</td>
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<td>72</td>
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<td>13.9</td>
<td>110</td>
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<td>37</td>
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<td>74</td>
<td>13.2</td>
<td>111</td>
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<tr>
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<td>75</td>
<td>12.5</td>
<td>112</td>
<td>0.8</td>
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<tr>
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<td>43.5</td>
<td>76</td>
<td>11.9</td>
<td>113</td>
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<td>77</td>
<td>11.2</td>
<td>114</td>
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<tr>
<td>41</td>
<td>41.5</td>
<td>78</td>
<td>10.6</td>
<td>115</td>
<td>0.5</td>
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</tbody>
</table>
\section*{Example:} At age 71, Dr. Jones names Mrs. Jones as the beneficiary of his traditional IRA. At age 73, Mrs. Jones predeceases her husband. At that time, Dr. Jones names his children as beneficiaries. Three years later, Dr. Jones dies. Because Dr. Jones' children were the beneficiaries as of December 31 of the year following the year Dr. Jones died, RMDs are calculated based on the oldest child's life expectancy.

\section*{Example:} At age 71, Dr. Jones names Mrs. Jones as his primary beneficiary of his traditional IRA and his children as contingent beneficiaries. At age 73, Mrs. Jones predeceases her husband. Three years later, Dr. Jones dies. Despite the fact that Dr. Jones did not execute a new beneficiary designation form before his death, his children, as contingent beneficiaries, can be established as the beneficiaries as of December 31 of the year following the year Dr. Jones died. RMDs, therefore, are calculated based on the oldest child's life expectancy.

\section*{Example:} At age 71, Dr. Jones names Mrs. Jones as his primary beneficiary of his traditional IRA and his children as contingent beneficiaries. Three years later, at age 74, Dr. Jones dies. Mrs. Jones then disclaims the IRA. His children, as contingent beneficiaries, are the beneficiaries as of December 31 of the year following the year Dr. Jones died. RMDs, therefore, are calculated based on the oldest child's life expectancy.

\section*{Example:} Same facts as the preceding example except that the children create separate shares by December 31 of the year following the year of Dr. Jones' death. Each child can now use their individual life expectancy to calculate RMDs.

A client will need to ask the question, "Who is the best beneficiary of my IRA from both an income tax and an estate planning perspective?" From an estate planning perspective, one of the key goals is to fund the applicable exclusion amount (either outright or in a trust); whereas, from the income tax perspective, the goal is to maximize tax deferral. Generally, the maximum deferral is obtained when the client names his or her spouse as the beneficiary, and the spouse subsequently rolls over the funds into an IRA in his or her own name and subsequently names the children as the designated beneficiaries.

As shown in table 9.4, "Client Leaves $1 Million IRA to Child," distributions over a child's life expectancy can have a dramatic effect on the wealth transfer to children beneficiaries. If the taxpayer has enough
wealth, he or she should consider naming a grandchild, directly, as the beneficiary of a traditional or Roth IRA.

**Table 9.4: Client Leaves $1 Million IRA to Child**

<table>
<thead>
<tr>
<th>Year</th>
<th>Pension Fund Beginning Value</th>
<th>Life Expectancy</th>
<th>Annual Distribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>$1,000,000</td>
<td>42.5</td>
<td>$23,529</td>
</tr>
<tr>
<td>2002</td>
<td>$1,074,118</td>
<td>41.5</td>
<td>$25,882</td>
</tr>
<tr>
<td>2003</td>
<td>$1,153,060</td>
<td>40.5</td>
<td>$28,471</td>
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<tr>
<td>2004</td>
<td>$1,237,048</td>
<td>39.5</td>
<td>$31,318</td>
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<tr>
<td>2005</td>
<td>$1,326,303</td>
<td>38.5</td>
<td>$34,449</td>
</tr>
<tr>
<td>2006</td>
<td>$1,421,039</td>
<td>37.5</td>
<td>$37,894</td>
</tr>
<tr>
<td>2007</td>
<td>$1,521,460</td>
<td>36.5</td>
<td>$41,684</td>
</tr>
<tr>
<td>2008</td>
<td>$1,627,754</td>
<td>35.5</td>
<td>$45,852</td>
</tr>
<tr>
<td>2009</td>
<td>$1,740,092</td>
<td>34.5</td>
<td>$50,437</td>
</tr>
<tr>
<td>2010</td>
<td>$1,858,621</td>
<td>33.5</td>
<td>$55,481</td>
</tr>
<tr>
<td>2011</td>
<td>$1,983,454</td>
<td>32.5</td>
<td>$61,029</td>
</tr>
<tr>
<td>2012</td>
<td>$2,114,668</td>
<td>31.5</td>
<td>$67,132</td>
</tr>
<tr>
<td>2013</td>
<td>$2,252,290</td>
<td>30.5</td>
<td>$73,846</td>
</tr>
<tr>
<td>2014</td>
<td>$2,396,288</td>
<td>29.5</td>
<td>$81,230</td>
</tr>
<tr>
<td>2015</td>
<td>$2,546,564</td>
<td>28.5</td>
<td>$89,353</td>
</tr>
<tr>
<td>2016</td>
<td>$2,702,932</td>
<td>27.5</td>
<td>$98,288</td>
</tr>
</tbody>
</table>

**Example:** Dan names his ten-year old grandson, Dan III, as the beneficiary of his Roth IRA. At age 69, Dan dies. Distributions of the $1 million Roth IRA to his grandchild are shown in table 9.5, “Client Leaves $1 Million IRA to Grandchild.”

---

3 Assumes a beginning balance of $1 million with 10-percent growth, that estate taxes are paid from probate estate, and that the child is age 40 with a life expectancy of 42.5 years.
Table 9.5: Client Leaves $1 Million IRA to Grandchild

<table>
<thead>
<tr>
<th>Year</th>
<th>Pension Fund Beginning Value</th>
<th>Life Expectancy</th>
<th>Annual Distribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>$1,000,000</td>
<td>71.7</td>
<td>$13,947</td>
</tr>
<tr>
<td>2003</td>
<td>$1,084,658</td>
<td>70.7</td>
<td>$15,342</td>
</tr>
<tr>
<td>2004</td>
<td>$1,176,248</td>
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<td>$16,876</td>
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<tr>
<td>2005</td>
<td>$1,275,310</td>
<td>68.7</td>
<td>$18,563</td>
</tr>
<tr>
<td>2006</td>
<td>$1,382,421</td>
<td>67.7</td>
<td>$20,420</td>
</tr>
<tr>
<td>2007</td>
<td>$1,498,201</td>
<td>66.7</td>
<td>$22,462</td>
</tr>
<tr>
<td>2008</td>
<td>$1,623,313</td>
<td>65.7</td>
<td>$24,708</td>
</tr>
<tr>
<td>2009</td>
<td>$1,758,466</td>
<td>64.7</td>
<td>$27,179</td>
</tr>
<tr>
<td>2010</td>
<td>$1,904,416</td>
<td>63.7</td>
<td>$29,897</td>
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<td>2011</td>
<td>$2,061,971</td>
<td>62.7</td>
<td>$32,886</td>
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<td>2012</td>
<td>$2,231,993</td>
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<td>$36,175</td>
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<td>2013</td>
<td>$2,415,400</td>
<td>60.7</td>
<td>$39,792</td>
</tr>
<tr>
<td>2014</td>
<td>$2,613,168</td>
<td>59.7</td>
<td>$43,772</td>
</tr>
<tr>
<td>2015</td>
<td>$2,826,336</td>
<td>58.7</td>
<td>$48,149</td>
</tr>
<tr>
<td>2016</td>
<td>$3,056,006</td>
<td>57.7</td>
<td>$52,964</td>
</tr>
</tbody>
</table>

After the Roth IRA has been completely liquidated in 72 years, Dan III has received almost $130,000,000 of tax-free distributions.

Naming a New Beneficiary after Age 70½

Under the law, there is no required beginning date for the Roth IRA. Accordingly, after age 70½, one can name a new beneficiary, a designation that will be effective for both property law and income tax purposes. Prior to the new proposed IRA Regulations, when working with traditional IRAs, one of the biggest stumbling blocks was the fact that if a client’s spouse died after the client’s required beginning date, the client was not allowed to name a beneficiary with a longer life expectancy for income tax purposes. Several examples follow.

Example: John, age 75, named his spouse Jane as the designated beneficiary of his $500,000 traditional IRA as of his required beginning date. Jane predeceases John. Under the old regulations, John was not

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4 Assumes a beginning balance of $1 million with 10-percent growth, that estate taxes are paid from probate estate, and that the child is age 10 with a life expectancy of 71.7 years.

A 10-percent growth rate is assumed.

6 IRC Section 408A(c)(5).

7 Instead of the client’s beneficiary for property law purposes was required to take distributions over the client and his deceased spouse’s remaining life expectancy, if any. However, if the client’s new beneficiary had a shorter life expectancy than his spouse, the new beneficiary’s life expectancy dictated distributions.
allowed to name a new beneficiary with a longer life expectancy in order to calculate his RMD. He would have been required to take his RMD based on the elections he made at his required beginning date, presumably over both his and his deceased spouse’s remaining fixed life expectancy. Under the new regulations, distributions will be available over the life expectancy of each new beneficiary. This is also the case for a Roth IRA. With a Roth IRA, he could name his children and have no RMDs during his lifetime. At John’s death, his children will be able to take the Roth IRA out over their single life expectancy. Because no RMDs are required during John’s lifetime, this allows for substantially more deferral when compared to a traditional IRA.

One of the key advantages of both traditional IRAs and Roth IRAs is the ability to stretch an IRA over the life expectancy of the designated beneficiary. The greatest wealth transfer will generally coincide with the longest deferral period.
PREPARING BENEFICIARY

DESIGNATION FORMS

chapter X
Planners helping their clients with beneficiary forms are always advised to approach a beneficiary designation form with the same care used to approach a will. It is prudent to have the client's legal counsel review the beneficiary designation form, and it may often be more practical to have legal counsel draft the form in that the contingent and secondary beneficiary designations may become extremely complex from a drafting perspective. Secondary and contingent beneficiaries are commonly trusts for the benefit of minor children, a family trust, or other nominee necessitating integration with the client's overall estate plan. Whether the preparation of a beneficiary form without the guidance of an attorney is the unauthorized practice of law is a matter better left to other studies. Generally, customized drafting will be required for any beneficiary designation form. The standardized forms provided by the brokerage or similar firms simply do not provide enough flexibility (in many cases simply not enough space) for proper drafting.

**COMMUNITY PROPERTY ISSUES**

Community property has special issues that affect beneficiary designation forms. In many states, notwithstanding the fact that the individual retirement account (IRA) is in the name of one spouse (for example, the wife), if the IRA is a community property asset, up to 50 percent of the IRA may be owned by each spouse. Thus, the overall estate plan must take into account the death of either spouse.¹

**Example:** Rick has a $500,000 IRA which is community property under state law at the time of his death. Because of the community property law, Rick is not able to leave 100 percent of the IRA to a bypass trust for his family but only his community property interest of 50 percent. The other 50 percent interest, under state law, is his spouse’s property.

This provides the nine community or marital property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin) with a tremendous planning strategy. The following is a typical situation.

**Example:** Brent and Amy come to you for some estate planning advice. Their total estate consists of $1,600,000, of which $1,200,000 is in Brent’s

¹ The recent tax court case, *Bunney v. Commissioner*, 114 TC 259 (2000), has cast some doubt on the ability to rely on community property laws in order to establish ownership of an IRA in the nontitled spouse.
IRA. In a separate property state, the practitioner can only reclassify $400,000 of property in Amy’s name, thereby losing $600,000 of Amy’s estate tax exemption ($1,000,000 less $400,000). On the other hand, the practitioner in a community property state can break off a section of the $1,200,000 IRA, say $500,000, and classify that IRA as community property. Now, if Amy dies first, she has $400,000 of other assets and a $250,000 claim in Brent’s IRA because it is classified as community property. She will have enough assets to fund her unified credit trust. This planning results in substantial estate tax savings. At Brent’s death, his estate would be $950,000 ($1,600,000 less $650,000).

### REVIEWING THE PLAN OR IRA DOCUMENT

Although tax law is a critical consideration when preparing a beneficiary designation form, the IRA or plan document is equally important. In many instances, the plan document may be more restrictive than the tax law. For example, many older plans may still provide that after a participant’s death, distributions must be taken over a five-year period. In contrast, a more recent plan might provide that distributions may be taken over a beneficiary’s life expectancy.

### DRAFTING IN ANTICIPATION OF DISCLAIMER

When preparing beneficiary designation forms, the client should generally consider designating his or her spouse as the primary beneficiary with the contingent beneficiary being a bypass trust (see the following sections). This allows rollover flexibility while having a contingency provision to fund a bypass trust. (See chapter 12, “Estate Planning for the Roth IRA,” regarding estate planning.)

### CREATING SEPARATE SHARES AT DEATH

Under the old proposed regulations, it was advisable for many clients to create more than one IRA before reaching their required beginning date in order to utilize each beneficiary’s individual life expectancy. Under the new proposed regulations, the creation of separate IRAs can be done after death, but before December 31 of the year following the year of death. For example, if Tony, a widower, has two children who are ages 40 and
50, the beneficiaries may be well advised to create separate traditional or Roth IRAs upon Tony's death. Each child is then able to use his or her own life expectancy to determine distributions from the IRA. A provision should be added to the beneficiary designation form giving the beneficiaries the power to create these separate shares. Keeping a single IRA during life simplifies the administration of an IRA.

**Table 10.1: Distributions Over Life Expectancy for Adult Children**

<table>
<thead>
<tr>
<th>40-Year-Old Child</th>
<th>50-Year-Old Child</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Beginning Balance</strong></td>
<td><strong>Life Expectancy</strong></td>
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<td>$500,000</td>
<td>42.5</td>
</tr>
<tr>
<td>$537,059</td>
<td>41.5</td>
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<td>$576,529</td>
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<td>$618,524</td>
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<td>$1,432,550</td>
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<td>$1,516,341</td>
<td>25.5</td>
</tr>
<tr>
<td>$1,602,564</td>
<td>24.5</td>
</tr>
<tr>
<td>$1,690,869</td>
<td>23.5</td>
</tr>
</tbody>
</table>

---

**Coordination with Revocable Trust**

The new proposed regulations were issued by the Internal Revenue Service (IRS) did not substantially change the requirements needed for a trust to be considered a designated beneficiary.

Prop. Regs. Sec. 1.401(a)(9)-4 Q&A 5(b) states that in order for a trust to be a designated beneficiary, the following requirements must be met.

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If Tony dies after his required beginning date, the year of death RMD must be calculated based on Tony's age in the year of death.
The Professional’s Guide to the Roth IRA: Implementing the 2001 Tax Act

1. The trust is a valid trust under state law, or would be but for the fact that there is no corpus.
2. The trust is irrevocable or will, by its terms, become irrevocable upon the death of the participant.
3. The beneficiaries of the trust who are beneficiaries with respect to the trust’s interest in the participant’s benefit are identifiable from the trust instrument.
4. The documentation required has been provided to the plan administrator.

Prop. Regs. Sec. 1.401(a)(9)-4 Q&A 6 creates new requirements as to when this documentation must be provided to the plan administrator. The following is an outline of when the documentation must be submitted to the plan administrator.

For lifetime distributions, the participant must perform one of the following.

1. Provide the plan administrator with a copy of the trust instrument and agree that if the trust instrument is amended at any time in the future, the participant will, within a reasonable time, provide a copy of the amendment to the plan administrator.

2. Provide the plan administrator with a list of all the beneficiaries (contingent and remainder with a description of the conditions of their entitlement) of the trust; certify to the best of the participant’s knowledge that this list is correct and complete and that the specific requirements of the trust are met; agree to provide corrected certifications to the extent that there are any amendments or changes to the information previously submitted; and agree to provide a copy of the trust instrument to the plan administrator upon demand.

In order to satisfy the documentation requirement after the death of the participant, by December 31 of the year following the year of the death of the participant, the trustee must perform the following.

1. Provide the plan administrator with a final list of all beneficiaries (contingent and remainder with a description of the conditions of their entitlement) of the trust as of December 31 of the year following the year of death; certify that to the best of the trustee’s knowledge, this list is correct.
and complete and that the specific requirements of the trust are met; and agree to provide a copy of the trust instrument to the plan administrator upon demand.

2. Provide the plan administrator with a copy of the actual trust document for the trust that was named as a beneficiary as of the participant’s date of death.

If a trust allows for payments of debts or expenses of the deceased IRA owner, the trust is disqualified as a designated beneficiary because the estate is a defacto nonqualified beneficiary. Apparently, the Service will allow an individual retirement account (IRA) to be included for the payment of estate tax without issue. However, proceed with caution.

Under the new proposed regulations, a question exists as to whether the trust may assign (meaning, distribute) a portion of the IRA to pay for such expenses, thereby achieving designated beneficiary status and allowing use of the trust beneficiary’s life expectancy. Such an assignment must be made prior to December 31 of the year following the year of death in order for the trust to achieve a designated beneficiary status. An argument can then be made for the use of the beneficiary’s life expectancies. In this case, because the position the IRS will take on such action is unclear, a Private Letter Ruling will be required.

FUNDING THE CREDIT SHELTER TRUST

An important question for estate planning clients is, “Should my traditional IRA or my Roth IRA be payable to my credit shelter trust?” Initial analysis shows that paying the Roth IRA to the credit shelter trust is more beneficial. This is true because income tax has already been paid on the Roth IRA. Thus, 100 percent of the funds passing to the bypass trust eventually pass to the taxpayer’s family, compared with a traditional IRA used to fund the bypass trust. In the latter case, income taxes may absorb up to 39.6 percent of a traditional IRA.

Example: At the time of Harold’s death, $600,000 passes from his Roth IRA into an irrevocable IRA trust. The entire $600,000 continues working for Harold’s family. Minimum distributions are required over the oldest beneficiary’s life expectancy, which at age forty-seven is 35.9 years, and once the distributions start, 100 percent of the distribution may be invested for the benefit of the taxpayer’s family: there will be no income tax due on the required minimum distribution (RMD) because of the Roth IRA. See table 10.2, “Roth IRA Analysis—Post-Death Situation.”
### Table 10.2: Roth IRA Analysis—Post-Death Situation

<table>
<thead>
<tr>
<th>Year</th>
<th>Required Minimum Distribution</th>
<th>Taxes at 0%</th>
<th>Beginning Outside Balance</th>
<th>Growth at 10%</th>
<th>Taxes at 20%</th>
<th>Ending Outside Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>$16,713</td>
<td>$0</td>
<td>$16,713</td>
<td>$1,671</td>
<td>($334)</td>
<td>$18,050</td>
</tr>
<tr>
<td>2003</td>
<td>$18,384</td>
<td>$0</td>
<td>$36,435</td>
<td>$3,643</td>
<td>($729)</td>
<td>$39,349</td>
</tr>
<tr>
<td>2004</td>
<td>$20,223</td>
<td>$0</td>
<td>$59,572</td>
<td>$5,957</td>
<td>($1,191)</td>
<td>$64,338</td>
</tr>
<tr>
<td>2005</td>
<td>$22,245</td>
<td>$0</td>
<td>$86,583</td>
<td>$8,658</td>
<td>($1,732)</td>
<td>$93,510</td>
</tr>
<tr>
<td>2006</td>
<td>$24,470</td>
<td>$0</td>
<td>$117,979</td>
<td>$11,798</td>
<td>($2,360)</td>
<td>$127,418</td>
</tr>
<tr>
<td>2007</td>
<td>$26,917</td>
<td>$0</td>
<td>$154,334</td>
<td>$15,433</td>
<td>($3,087)</td>
<td>$166,681</td>
</tr>
<tr>
<td>2008</td>
<td>$29,608</td>
<td>$0</td>
<td>$196,289</td>
<td>$19,629</td>
<td>($3,926)</td>
<td>$211,992</td>
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<td>2009</td>
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<td>$0</td>
<td>$244,562</td>
<td>$24,456</td>
<td>($4,891)</td>
<td>$264,126</td>
</tr>
<tr>
<td>2010</td>
<td>$35,826</td>
<td>$0</td>
<td>$299,952</td>
<td>$29,995</td>
<td>($5,999)</td>
<td>$323,949</td>
</tr>
<tr>
<td>2011</td>
<td>$39,409</td>
<td>$0</td>
<td>$363,357</td>
<td>$36,336</td>
<td>($7,267)</td>
<td>$392,426</td>
</tr>
<tr>
<td>2012</td>
<td>$43,349</td>
<td>$0</td>
<td>$435,775</td>
<td>$43,578</td>
<td>($8,716)</td>
<td>$470,637</td>
</tr>
<tr>
<td>2013</td>
<td>$47,684</td>
<td>$0</td>
<td>$518,322</td>
<td>$51,832</td>
<td>($10,366)</td>
<td>$559,787</td>
</tr>
<tr>
<td>2014</td>
<td>$52,453</td>
<td>$0</td>
<td>$612,240</td>
<td>$61,224</td>
<td>($12,245)</td>
<td>$661,219</td>
</tr>
<tr>
<td>2015</td>
<td>$57,698</td>
<td>$0</td>
<td>$718,918</td>
<td>$71,892</td>
<td>($14,378)</td>
<td>$776,431</td>
</tr>
<tr>
<td>2016</td>
<td>$63,468</td>
<td>$0</td>
<td>$839,899</td>
<td>$83,990</td>
<td>($16,798)</td>
<td>$907,091</td>
</tr>
</tbody>
</table>

**Example:** Same as the preceding example, but a traditional IRA is used to fund the irrevocable IRA trust. See table 10.3, “Traditional IRA Analysis—Post-Death Situation,” and figure 10.1, “Traditional IRA Versus Roth IRA.”

### Table 10.3: Traditional IRA Analysis—Post-Death Situation

<table>
<thead>
<tr>
<th>Year</th>
<th>Required Minimum Distribution</th>
<th>Taxes at 0%</th>
<th>Beginning Outside Balance</th>
<th>Growth at 10%</th>
<th>Taxes at 20%</th>
<th>Ending Outside Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>$16,713</td>
<td>($6,017)</td>
<td>$10,696</td>
<td>$1,070</td>
<td>($2,124)</td>
<td>$11,552</td>
</tr>
<tr>
<td>2003</td>
<td>$18,384</td>
<td>($6,618)</td>
<td>$23,318</td>
<td>$2,332</td>
<td>($4,666)</td>
<td>$25,184</td>
</tr>
<tr>
<td>2004</td>
<td>$20,223</td>
<td>($7,280)</td>
<td>$38,126</td>
<td>$3,813</td>
<td>($7,63)</td>
<td>$41,176</td>
</tr>
<tr>
<td>2005</td>
<td>$22,245</td>
<td>($8,008)</td>
<td>$55,413</td>
<td>$5,541</td>
<td>($1,108)</td>
<td>$59,846</td>
</tr>
<tr>
<td>2006</td>
<td>$24,470</td>
<td>($8,809)</td>
<td>$75,507</td>
<td>$7,551</td>
<td>($1,510)</td>
<td>$81,547</td>
</tr>
<tr>
<td>2007</td>
<td>$26,917</td>
<td>($9,690)</td>
<td>$98,774</td>
<td>$9,877</td>
<td>($1,975)</td>
<td>$106,676</td>
</tr>
<tr>
<td>2008</td>
<td>$29,608</td>
<td>($10,659)</td>
<td>$125,625</td>
<td>$12,563</td>
<td>($2,513)</td>
<td>$135,675</td>
</tr>
<tr>
<td>2009</td>
<td>$32,569</td>
<td>($11,725)</td>
<td>$156,519</td>
<td>$15,652</td>
<td>($3,130)</td>
<td>$169,041</td>
</tr>
<tr>
<td>2010</td>
<td>$35,826</td>
<td>($12,897)</td>
<td>$191,970</td>
<td>$19,197</td>
<td>($3,839)</td>
<td>$207,327</td>
</tr>
<tr>
<td>2011</td>
<td>$39,409</td>
<td>($14,187)</td>
<td>$232,549</td>
<td>$23,255</td>
<td>($4,651)</td>
<td>$251,153</td>
</tr>
<tr>
<td>2012</td>
<td>$43,349</td>
<td>($15,606)</td>
<td>$278,896</td>
<td>$27,890</td>
<td>($5,578)</td>
<td>$301,208</td>
</tr>
<tr>
<td>2013</td>
<td>$47,684</td>
<td>($17,166)</td>
<td>$331,726</td>
<td>$33,173</td>
<td>($6,635)</td>
<td>$358,264</td>
</tr>
<tr>
<td>2014</td>
<td>$52,453</td>
<td>($18,883)</td>
<td>$391,854</td>
<td>$39,183</td>
<td>($7,837)</td>
<td>$423,180</td>
</tr>
<tr>
<td>2015</td>
<td>$57,698</td>
<td>($20,771)</td>
<td>$460,107</td>
<td>$46,011</td>
<td>($9,202)</td>
<td>$496,916</td>
</tr>
<tr>
<td>2016</td>
<td>$63,468</td>
<td>($22,848)</td>
<td>$537,535</td>
<td>$53,754</td>
<td>($10,751)</td>
<td>$580,538</td>
</tr>
</tbody>
</table>
Figure 10.1: Traditional IRA Versus Roth IRA
TAX PLANNING AT THE

DEATH OF THE FIRST SPOUSE

chapter XI
At the death of the first spouse, the surviving spouse is confronted with the following choices.

- Roll the individual retirement account (IRA) or Roth IRA funds over into his or her own name.
- Disclaim the funds.
- Leave the funds in a beneficial IRA.

These choices are primarily driven by estate and income-tax planning concerns and, to a lesser extent, legal and asset protection issues. When providing advice to a client at the death of the first spouse, you should move quickly to determine what beneficiary designations are currently in place and to determine whether disclaimers are needed. The plan document should always be reviewed soon after a client dies. The steps to follow are listed in figure 11.1, “A Checklist for Minimum Distributions After Death.”

**Figure 11.1: A Checklist for Minimum Distributions Upon Death for Traditional IRAs**

<table>
<thead>
<tr>
<th></th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Is there a beneficiary?</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>2. Is the spouse the sole beneficiary?</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>3. Are there multiple beneficiaries?</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>a. Do all of the beneficiaries qualify as an designated beneficiary?</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>b. Is the spouse one of the beneficiaries?</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>4. Did death occur before the required beginning date?</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>a. Are all of the beneficiaries taking distribution over life expectancy?</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>b. Have separate accounts been established?</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>c. Will the five-year rule apply?</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>5. Did death occur after the required beginning date?</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>a. Is the spouse the beneficiary?</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>b. If there are multiple beneficiaries, do all of them qualify as a designated beneficiary?</td>
<td>☐</td>
<td>☐</td>
</tr>
</tbody>
</table>

Since Roth IRAs are not subject to required minimum distributions (RMDs) during the IRA owner’s lifetime, the required beginning date in the preceding checklist is not relevant for Roth IRAs. Therefore, a checklist for minimum distributions upon death of a Roth IRA owner would not include question 5, “Did death occur after the required beginning date?” in the checklist shown in Figure 11.1. The distribution
rules upon death of a Roth IRA owner are the same as those that apply to traditional IRAs if death occurs before the required beginning date.\(^1\)

When meeting with a surviving spouse, one of your first roles is to determine whether sufficient resources exist to fund the unified credit exemption. If a spouse is named as the primary beneficiary of an IRA, he or she may need to disclaim all or a portion of the IRA to help fund the bypass trust. This is accomplished by having the trust as contingent beneficiary and it should be in place prior to the IRA owner’s death.

### Tax Planning When the IRA Passes to the Spouse

The surviving spouse may make several elections at the death of a spouse with regard to both a traditional IRA and a Roth IRA.

The surviving spouse may elect to roll the IRA over into either a new or existing IRA in his or her own name.\(^2\) Unlike the rules that apply to traditional IRAs, the rules that apply to Roth IRAs do not require distributions during the Roth IRA owner’s lifetime.

**Example:** Harold dies at age 74. Following Harold’s death, his wife, Julie, age 73, rolls both his traditional IRA and Roth IRA into newly established traditional and Roth IRAs in her own name and establishes new beneficiaries. Because Julie has already attained the required beginning date, she must begin distributions from the traditional IRA. However, no distributions are required from Julie’s rollover Roth IRA until her death.

If the deceased spouse had not reached the required beginning date, the surviving spouse may continue to maintain the traditional IRA in the deceased spouse’s name, deferring distributions until the year in which the deceased spouse would have attained the required beginning date had death not occurred.\(^3\)

**Example:** Marvin dies at age 68. His wife, Maria, does not roll over the IRA; she maintains it in Marvin’s name. Maria is not required to begin distributions until Marvin would have obtained age 70½.\(^4\) However, as a practical matter, if Maria does not roll the IRA over into an IRA in her

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2 Internal Revenue Code (IRC) Section 408A(c)(6)(A) and IRC Section 408A(c).
3 IRC Section 401(a)(9)(B)(iv)(f).
4 IRC Section 401(a)(9)(B)(iv)(f).
own name, she will not be allowed to name a new beneficiary for tax purposes. In other words, the inherited IRA concept will not be available.

**TRUST AS BENEFICIARY**

When a trust is the designated beneficiary of a Roth IRA, distributions are then made over the life expectancy of the oldest trust beneficiary.⁵

**Example:** Lou dies at age 72, naming an irrevocable trust for the benefit of his wife, Martha, age 70, and his daughter, Lydia, age 40. Distributions are made over Martha’s life expectancy.

**Example:** Same facts as the preceding example, except that two separate trusts are created by December 31 of the year following the year of Lou’s death. Distributions for Martha’s share are made over her life expectancy and distributions for Lydia’s share are made over Lydia’s life expectancy.

**SPOUSAL DISCLAIMER**

Under the property law of most states, the surviving spouse is allowed to disclaim assets passing under a beneficiary designation form. When a surviving spouse executes a disclaimer, the funds within a traditional IRA or Roth IRA pass to the next beneficiary as if the disclaiming spouse predeceased the owner. The next beneficiary is often a trust for the benefit of the surviving spouse, the children of the couple, or both. The new beneficiary or beneficiaries resulting from the disclaimer are able to utilize their life expectancy(ies) to determine RMDs.

**TAX PLANNING WHEN A ROTH IRA PASSES TO A NONSPOUSAL BENEFICIARY**

When a Roth IRA passes to a designated beneficiary who is not the spouse, distributions are based on the beneficiary’s life expectancy and must begin by December 31 of the year following the year of the owner’s death. The designated beneficiary’s life expectancy is determined in the year following the year of the owner’s death and is reduced by one year for each year thereafter. If there are multiple beneficiaries and all qualify as

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⁵ However, if separate trusts are created by December 31 of the year following the year of the participant’s death, each trust beneficiary can use their individual life expectancy.
designated beneficiaries and separate accounts have been established by December 31 of the year following the year of death, then each beneficiary can take distributions based on his or her individual life expectancy. If separate accounts have not been established, then distributions to all beneficiaries must be based on the oldest beneficiary’s life expectancy.

**Example:** Alan dies when his child, the named beneficiary of his IRA, has a 46.3 year life expectancy. Distributions are made during the 46.3 years. There is a beginning balance of $1 million and a projected 10-percent growth rate. This is illustrated in table 11.1, “Distributions After Alan’s Death.”

**Table 11.1: Distributions After Alan’s Death**

<table>
<thead>
<tr>
<th>Year</th>
<th>Pension Fund Beginning Value</th>
<th>Life Expectancy</th>
<th>Annual Distribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>$1,000,000</td>
<td>46.3</td>
<td>$21,598</td>
</tr>
<tr>
<td>2002</td>
<td>$1,076,242</td>
<td>45.3</td>
<td>$23,758</td>
</tr>
<tr>
<td>2003</td>
<td>$1,157,732</td>
<td>44.3</td>
<td>$26,134</td>
</tr>
<tr>
<td>2004</td>
<td>$1,244,758</td>
<td>43.3</td>
<td>$28,747</td>
</tr>
<tr>
<td>2005</td>
<td>$1,337,612</td>
<td>42.3</td>
<td>$31,622</td>
</tr>
<tr>
<td>2006</td>
<td>$1,436,589</td>
<td>41.3</td>
<td>$34,784</td>
</tr>
<tr>
<td>2007</td>
<td>$1,541,986</td>
<td>40.3</td>
<td>$38,263</td>
</tr>
<tr>
<td>2008</td>
<td>$1,654,095</td>
<td>39.3</td>
<td>$42,089</td>
</tr>
<tr>
<td>2009</td>
<td>$1,773,207</td>
<td>38.3</td>
<td>$46,298</td>
</tr>
<tr>
<td>2010</td>
<td>$1,899,600</td>
<td>37.3</td>
<td>$50,928</td>
</tr>
<tr>
<td>2011</td>
<td>$2,033,539</td>
<td>36.3</td>
<td>$56,020</td>
</tr>
<tr>
<td>2012</td>
<td>$2,175,271</td>
<td>35.3</td>
<td>$61,622</td>
</tr>
<tr>
<td>2013</td>
<td>$2,325,014</td>
<td>34.3</td>
<td>$67,785</td>
</tr>
<tr>
<td>2014</td>
<td>$2,482,952</td>
<td>33.3</td>
<td>$74,563</td>
</tr>
<tr>
<td>2015</td>
<td>$2,649,228</td>
<td>32.3</td>
<td>$82,019</td>
</tr>
<tr>
<td>2016</td>
<td>$2,823,930</td>
<td>31.3</td>
<td>$90,221</td>
</tr>
<tr>
<td>2017</td>
<td>$3,007,080</td>
<td>30.3</td>
<td>$99,244</td>
</tr>
<tr>
<td>2018</td>
<td>$3,198,620</td>
<td>29.3</td>
<td>$109,168</td>
</tr>
<tr>
<td>2019</td>
<td>$3,398,397</td>
<td>28.3</td>
<td>$120,085</td>
</tr>
</tbody>
</table>

If a trust is the beneficiary and it is a qualified trust, then distributions to the trust will be based on the oldest trust beneficiary’s life expectancy. If the trust is not a qualified trust, then distributions to the trust will be made under the five-year rule unless the participant dies after his required beginning date. In that case, distributions of the trust must be taken for the year of death based upon the owner’s age in the year of death based on the Uniform Table. For succeeding years, the life expectancy factor is determined by referencing the owner’s age in the year of death in Treas. Reg. Sec. 1.72-9. This factor is reduced by one for every year thereafter.
GIFTS TO CHARITY

Clients with charitable intentions should leave their traditional IRAs to a charity, retaining their other assets and Roth IRAs for the benefit of their families. If a traditional IRA is left to charity, the IRA will not be subject to either income or estate tax and since the charity is tax-exempt, no income tax will be paid with regard to the IRA and Section 2055 charitable estate tax deduction will also be obtained. If a Roth IRA were to pass to charity, the income tax advantage is lost.

THE INHERITED-IRA CONCEPT

The inherited-IRA concept considers the effect of arranging a client’s affairs so that the balance in a large IRA (or qualified retirement plan) can be inherited intact by the client’s children upon the death of the surviving spouse or upon the death of the client, if unmarried at the time of death. This concept can also be used even if the client has no children but wishes to leave the IRA to other beneficiaries such as nieces, nephews, brothers, or sisters. The key advantage of this strategy is that it allows the beneficiaries to keep the IRA assets intact in an income tax-deferred environment and take withdrawals from the inherited IRA over their own life expectancies. If properly executed and funded, this strategy can create substantial wealth transfer opportunities for clients.

Ordinarily, the IRA distribution strategy that provides for the greatest benefit to a family is the strategy that provides the greatest deferral of taxes. Deferring withdrawals from the IRA or qualified retirement plan for as long as possible usually results in the greatest family wealth transfer.

To permit this long-term deferral strategy to work, there must be sufficient liquidity, from a source other than the IRA, to pay the estate and excise taxes that would be due. Typically, if the client is married, the surviving spouse will roll over IRA assets into a new IRA in his or her name. The estate tax is deferred until the surviving spouse’s death at which time the estate taxes due on the total taxable estate are payable within nine months of the surviving spouse’s death. Unless the estate taxes can be paid from another source, the IRA is invaded to pay these taxes.

When beneficiaries must withdraw funds from a traditional IRA to pay the estate taxes, the amount withdrawn is subject to income tax. This results in a negative tax spiral, ultimately resulting in a total tax loss of up to 70
percent to 80 percent of the original traditional IRA balance, leaving only 20 percent to 30 percent of the funds for the client’s heirs.

**Example:** Gene dies at age 75, naming his wife, Amy, as the beneficiary of his traditional IRA. Subsequent to Gene’s death, Amy rolls the funds over into an IRA in her own name, naming their only child as the beneficiary. Later, at Amy’s death, the child’s adjusted life expectancy is 40 years. Distributions will be made over the life expectancy of the beneficiary. If, for example, the balance of the IRA was $2 million at Amy’s death and the beneficiary had a 40-year life expectancy, only $50,000 need be withdrawn in the first year. The negative tax spiral is shown in table 11.2, “Negative Tax Spiral for a $3 Million Taxable Estate With Death Occurring in 2000.”

**Table 11.2: Negative Tax Spiral for a $3 Million Taxable Estate With Death Occurring in 2000**

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>IRA balance</td>
<td>$2,000,000</td>
<td>100%</td>
</tr>
<tr>
<td>Estate tax</td>
<td>(945,000)</td>
<td>47.25%</td>
</tr>
<tr>
<td>Income tax</td>
<td>(378,800)</td>
<td>18.94%</td>
</tr>
<tr>
<td>Net to heirs</td>
<td>$ 676,200</td>
<td></td>
</tr>
<tr>
<td>Percentage to heirs</td>
<td></td>
<td>33.81%</td>
</tr>
<tr>
<td>Percentage to taxes</td>
<td></td>
<td>66.19%</td>
</tr>
</tbody>
</table>

To prevent this devastating depletion of wealth, the source of funds to pay the estate taxes should come from outside the IRA. In a number of circumstances, other liquid assets may be available for this purpose. However, the IRA assets commonly represent the bulk of an estate. Therefore, it may be appropriate to consider the purchase of life insurance to provide the liquidity needed to keep the IRA intact.

In practice, this strategy is implemented by establishing an irrevocable life insurance trust with your client’s heirs as beneficiaries. The trustee purchases a survivorship life insurance policy or, in the case of a surviving spouse or unmarried client, a single life policy. Upon the death of the insured, the life insurance proceeds are paid to the trust. To the extent needed to pay estate taxes, cash could be either loaned to the estate, used to purchase estate assets, or distributed to the beneficiaries of the trust. This prevents the need for beneficiaries to withdraw funds from the IRA to pay the taxes. Upon death of the IRA owner, the beneficiaries can receive distributions over their life expectancies.
See chapter 12, "Estate Planning for the Roth IRA," for a further discussion of the inherited-IRA concept.

■ ■ ■

**Roth Conversions at First Death**

A potential planning opportunity for a Roth IRA conversion is after the death of the original traditional IRA owner. In many situations, the surviving spouse will roll over the traditional IRA into his or her own IRA. At this point, there may be a large IRA balance and a modest need for the IRA funds. In addition, there may also be liquid assets available to pay the Roth IRA conversion taxes because the typical planning will take advantage of the unified credit with the remaining assets passing to the surviving spouse, avoiding estate tax at the first death. Even though there will be no estate tax at the first death, there may be an estate tax at the second death. If this is the case, serious consideration should be given to making a Roth IRA conversion because of the many estate tax advantages of utilizing a Roth IRA.
Estate Planning for the

Roth IRA

Chapter XII
For estate planning purposes, the Roth individual retirement account (IRA) provides a wide range of opportunities. In years to come, many clients will strategically name a unified credit trust as the beneficiary of their Roth IRAs. By using the Roth IRA (compared to a traditional IRA) to fund the bypass trust, these clients will be able to use assets that will not be subject to income tax in the future.

Under the Economic Growth and Tax Relief Act of 2001 (the 2001 Act), the amount that can be used to fund a credit shelter trust is greatly increased as shown in table 12.1, “Growth in Credit Shelter Trust by Year.”

**Table 12.1: Growth in Credit Shelter Trust by Year**

<table>
<thead>
<tr>
<th>Year</th>
<th>Unified Credit Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>2003</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>2004</td>
<td>$1,500,000</td>
</tr>
<tr>
<td>2005</td>
<td>$1,500,000</td>
</tr>
<tr>
<td>2006</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>2007</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>2008</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>2009</td>
<td>$3,500,000</td>
</tr>
<tr>
<td>2010</td>
<td>Estate tax eliminated</td>
</tr>
<tr>
<td>2011</td>
<td>Estate tax reinstated unless Congress acts</td>
</tr>
</tbody>
</table>

### The Effect on Estate Tax Liability

For many taxpayers with substantial wealth in their qualified plan or IRA, the analysis of whether to convert a traditional IRA to a Roth IRA should include the effect of estate taxes. Estate planning affects this decision in the following three ways.

1. If an IRA is converted to a Roth IRA, the overall estate is reduced by the amount of the income taxes paid. This results in a lower overall estate tax base.

   • **Example:** Tom and Sue have an IRA valued at $1 million. If they elect to convert the IRA to a Roth IRA, their estate is decreased by $400,000 assuming a 40-percent income tax rate.
2. From a wealth-transfer perspective, it is often better to pay income tax before paying estate tax. See table 12.2, “Benefit of Paying Income Tax Before the Estate Tax.”

3. It will generally be advantageous to fund the bypass trust with Roth IRA assets rather than with a traditional IRA. See table 12.3, “The Value of Assets Passing to the Bypass Trust.”

**Table 12.2 Benefit of Paying Income Tax Before the Estate Tax**

<table>
<thead>
<tr>
<th>IRA balance</th>
<th>$1,000,000</th>
<th>$1,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less income tax at 39.1 percent</td>
<td>0</td>
<td>391,000</td>
</tr>
<tr>
<td>Less federal estate tax</td>
<td>470,000</td>
<td>0</td>
</tr>
<tr>
<td>Less state estate tax¹</td>
<td>80,000</td>
<td>0</td>
</tr>
<tr>
<td>Total taxes</td>
<td>550,000</td>
<td>391,000</td>
</tr>
<tr>
<td>Net to family</td>
<td>450,000</td>
<td>609,000</td>
</tr>
<tr>
<td>Less estate tax</td>
<td>0</td>
<td>334,950</td>
</tr>
<tr>
<td>Less income tax</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>IRA balance</td>
<td>$1,000,000</td>
<td></td>
</tr>
<tr>
<td>Less IRC Sec. 691(c) deduction</td>
<td>470,000</td>
<td></td>
</tr>
<tr>
<td>Taxable income</td>
<td>530,000</td>
<td></td>
</tr>
<tr>
<td>Less income tax at 39.1 percent</td>
<td>207,230</td>
<td></td>
</tr>
<tr>
<td>Net to family</td>
<td>$242,770</td>
<td>$271,800</td>
</tr>
</tbody>
</table>

**Analyzing the Interrelationship of Income Tax and Estate Tax**

At the time of a client’s death, the traditional IRA is subject to both income tax and estate tax. In contrast, the Roth IRA is subject only to the estate tax, because the income tax has already been paid. It is generally better to pay income tax before paying the estate tax. If, at the time of a client’s death, he or she holds a traditional IRA, it will be subject to estate tax based on the fair market value at the date of death.

**Example:** Tom owns an IRA valued at $2 million at his date of death. In this case $2 million is included in his estate. On the other hand, if Tom had already made a Roth IRA election and the IRA was valued at $1

¹ Assumed a weighted average rate of 8 percent. The lower the effective state soak up tax is, the less advantageous it will be to pay income tax first.
million, only $1 million would be included in his estate. Table 12.3, “The Value of Assets Passing to the Bypass Trust,” shows the impact of making the Roth IRA conversion election and unified credit funding versus the traditional IRA.

**Table 12.3: The Value of Assets Passing to the Bypass Trust**

<table>
<thead>
<tr>
<th></th>
<th>Traditional IRA</th>
<th>Roth IRA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exemption amount in 2002</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Less income taxes at 31 percent</td>
<td>(310,000)</td>
<td>0</td>
</tr>
<tr>
<td>Net to family</td>
<td>$690,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Additional wealth transfer</td>
<td></td>
<td>$310,000</td>
</tr>
</tbody>
</table>

The same logic will also apply to a generation-skipping transfer (GST) tax-exempt trust. The increased exemptions discussed above will also affect the importance of this type of planning.

### The IRC Section 691(c) Deduction Compared to Paying Income Tax First

Is it really better to pay income taxes first?

**Example:** Tony has a $3 million stock portfolio in addition to his $1 million IRA. At his death, his IRA will be exposed to a 55-percent estate tax. Table 12.2 illustrates the computation. (For ease of reference, death is assumed to occur on January 1, 2001.)

The wealth transfer is enhanced by $31,680 by paying the income tax before paying the estate tax. This occurs because the Internal Revenue Code (IRC) Section 691(c) deduction allows only for the deduction of federal estate tax. (The state estate tax is not deductible in determining federal taxable income.)

To further complicate these computations, the IRC Section 691(c) deduction for estate tax paid is subject to the 3-percent adjustment to itemized deductions. See also, discussion in chapter 5, “The Mathematics of the Traditional IRA Compared to the Nondeductible IRA and the Roth IRA.”
THE ESTATE TAX MARITAL DEDUCTION

Outright IRA distributions to a participant's surviving spouse generally qualify for the marital deduction under IRC Section 2056. IRA beneficiary designations payable to a marital deduction trust also qualify for the marital deduction. (See IRC Section 2056(b).)

Example: Joe dies and leaves his entire $1,200,000 estate to his spouse. This transfer qualifies for the marital deduction and will not be subject to estate tax.

Example: Assume the same facts as the previous example except that, instead of leaving his entire estate to his spouse outright, he leaves it in trust for her. If the trust qualifies as a Qualified Terminable Interest Property (QTIP) trust under IRC Section 2056(b), the assets left in trust for Joe’s spouse will qualify for the marital deduction.

THE ESTATE CHARITABLE DEDUCTION

Assets that are included in a decedent's gross estate and pass to qualified charities qualify for the charitable deduction. Qualified plan benefits and IRAs can be ideal assets to satisfy charitable gifts, because the amounts passing from the plan to the charity can escape both estate and income tax if properly structured. Charities do not qualify as designated beneficiaries and so do not qualify for the exception to the accelerated minimum distribution rules.

Under the old distribution regulations, if less than all of the account is to be paid to a charity, it was advised that a separate account be established for the charity's share to avoid tainting the entire account and so avoid the accelerated minimum distribution requirements as to the entire account.

The new distribution rules, however, provide opportunities for postmortem planning. The final determination date for beneficiaries is December 31 of the year following the year of death. If the beneficiary designation has a beneficiary that does not qualify under the law as a designated beneficiary, meaning, charity, that beneficiary could be "cashed

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2 IRC Section 2055.
4 See Prop. Reg. Sec. 1.401(a)(9)-1, Q&A E-5(a)(2).
out.” Only the beneficiaries remaining on December 31 of the year following the year of the owner’s death must be taken into consideration in determining distributions.

**Example:** Dr. Jones named his spouse, Mrs. Jones, a church and an adult child, Bill, as equal primary beneficiaries. The church, not a designated beneficiary, taints the individual beneficiaries. However, if the church receives its entitlement between the date of the owner’s death and December 31 of the year following the year of Dr. Jones’ death, it is no longer considered a beneficiary. Under this scenario, when the identity of the beneficiary is finalized (on December 31 of the year following the year of death) there are only two beneficiaries, Mrs. Jones and Bill. However, because a Roth IRA should never be subject to income tax, it should generally pass to one’s family and not to a charitable beneficiary.

**Revocable Trust**

IRC Section 401(a)(9) regulations allow a revocable trust to qualify for designated beneficiary status as long as it meets certain requirements. See chapter 13, “Naming a Trust Beneficiary of an IRA,” for a detailed discussion of the requirements for naming a trust as the beneficiary of retirement assets. If used, the revocable living trust should contain a fractional funding clause. This tax effect is important in creating and funding marital deduction estate plans. If a plan benefit or IRA is used to fund a marital or credit shelter bequest, it should be used to fund a fractional rather than a pecuniary formula bequest. Using the plan or IRA even to make a partial funding of a pecuniary bequest accelerates taxable income and should, therefore, ordinarily be avoided.⁶

**Source of Payment of Estate Tax**

When designing an estate plan for large traditional or Roth IRAs, you should understand how estate taxes are apportioned among probate and nonprobate assets. In a number of states, the estate tax is apportioned among each and every asset, whereas in other states the estate tax is borne by the probate estate. No federal statute apportions the estate tax against

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⁶ See Private Letter Rulings 9507008 and 9315016.
plan assets or IRAs, unlike the rules that require apportionment for life insurance,\(^7\) power-of-appointment assets,\(^8\) QTIP assets,\(^9\) or retained-interest assets.\(^10\) The following examples, absent specific guidance under state law, illustrate the federal apportionment treatment.

**Example:** John's $1,500,000 IRA is paid to children, and his will leaves the residue of his estate, $600,000, to his wife Sue. The entire estate tax is paid from the spouse's residual bequest. Further, to the extent that a tax is paid, the marital deduction is reduced, causing additional estate taxes to be paid.\(^11\)

**Example:** John's $500,000 IRA is paid to a son, and John's will leaves the residue of his probate estate (a $500,000 business) to his daughter. John's will does not allocate the estate tax liability. His daughter pays estate taxes of $153,000 on a taxable estate of $1 million. The son can take an in respect of a decedent (IRD) deduction under IRC Section 691(c), even though he did not pay an estate tax. The bottom line is that the daughter nets $347,000 ($500,000 - estate tax of $153,000 = $347,000); the son nets $373,000 ($500,000 IRA - income tax of $126,700 = $373,300).

A critical part of every plan is for you to work with legal counsel to determine exactly how estate taxes are apportioned among probate and nonprobate assets. Generally, it should be possible to override state law and for the estate planning documents to specify how estate taxes are apportioned. In these instances, it is often critical that estate taxes not be apportioned against IRAs or Roth IRAs but be apportioned against regular probate assets. This allows for the maximum deferral of both the traditional and Roth IRA.

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**The Generation-Skipping Transfer Tax**

Generally, transfers of property from a donor or decedent to a person who is, or who is deemed to be, two or more generations younger than the donor or decedent, are subject to the generation-skipping transfer (GST) tax.\(^12\)

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\(^7\) IRC Section 2206.  
\(^8\) IRC Section 2207.  
\(^9\) IRC Section 2207A.  
\(^10\) IRC Section 2207B.  
\(^12\) IRC Section 2601.
To the extent that it is likely that a client's IRA or Roth IRA bequest to a grandchild will exceed the client's remaining GST tax exemption, care should be taken to limit transfers to the grandchildren or, at a minimum, advise the client that the transfers will be subject to the GST tax. Under the 2001 Act, the GST tax exemption will equal the exemption equivalent of the unified credit against estate tax beginning in 2004, with a repeal in 2010. In 2002 and 2003, the exemption amount will be $1 million as adjusted for inflation.

If plan or IRA proceeds are distributed after the participant’s death to the participant’s grandchild, or to a trust of which the participant's grandchildren are the only beneficiaries, a direct skip occurs, subject to GST tax.\(^{13}\)

Utilizing a properly designed trust for the benefit of children and grandchildren is an important planning opportunity for many individuals. By utilizing this type of trust, a taxpayer can pass greater wealth to his or her grandchildren. Table 12.4, “Growth Resulting From Generation-Skipping Transfer Tax Exemption,” shows the additional wealth that the grandchildren receive by using a his or her GST exemption and a properly designed trust for the benefit of children and grandchildren versus giving the assets outright to the children.

**Table 12.4: Growth Resulting From Generation-Skipping Transfer Tax Exemption**

<table>
<thead>
<tr>
<th></th>
<th>Distributions To Children Outright</th>
<th>Distributions in Trust for Children and Grandchildren</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross estate</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Estate tax at child's death</td>
<td>550,000</td>
<td>0</td>
</tr>
<tr>
<td>Net to estate grandchildren</td>
<td>450,000</td>
<td>1,000,000</td>
</tr>
</tbody>
</table>

**Creating Wealth with the Roth IRA**

For the larger estate, the Roth IRA provides even more dynamic opportunities to create wealth for a client's family. Because minimum distributions are not required until the client’s death, it may be possible for a couple to build substantial wealth in their Roth IRAs. The key to

\(^{13}\) IRC Section 2612(c).
protecting this wealth is to assure adequate estate liquidity to allow for the Roth IRA to continue and to be distributed over the life expectancy of the beneficiaries. Table 12.5, "Client Leaves $500,000 IRA to Child," and table 12.6, "Client Leaves $500,000 to Grandchild," show distributions over the life expectancy of both a child's life expectancy (age 40) and grandchild's life expectancy (age 10):

Table 12.5: Client Leaves $500,000 IRA to Child

<table>
<thead>
<tr>
<th>Year</th>
<th>Pension Fund Beginning Value</th>
<th>Life Expectancy</th>
<th>Annual Distribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$500,000</td>
<td>42.5</td>
<td>$11,765</td>
</tr>
<tr>
<td>2</td>
<td>$537,059</td>
<td>41.5</td>
<td>$12,941</td>
</tr>
<tr>
<td>3</td>
<td>$576,529</td>
<td>40.5</td>
<td>$14,235</td>
</tr>
<tr>
<td>4</td>
<td>$618,524</td>
<td>39.5</td>
<td>$15,659</td>
</tr>
<tr>
<td>5</td>
<td>$663,151</td>
<td>38.5</td>
<td>$17,225</td>
</tr>
<tr>
<td>6</td>
<td>$710,519</td>
<td>37.5</td>
<td>$18,947</td>
</tr>
<tr>
<td>7</td>
<td>$760,729</td>
<td>36.5</td>
<td>$20,842</td>
</tr>
<tr>
<td>8</td>
<td>$813,876</td>
<td>35.5</td>
<td>$22,926</td>
</tr>
<tr>
<td>9</td>
<td>$870,045</td>
<td>34.5</td>
<td>$25,219</td>
</tr>
<tr>
<td>10</td>
<td>$929,309</td>
<td>33.5</td>
<td>$27,741</td>
</tr>
<tr>
<td>11</td>
<td>$991,725</td>
<td>32.5</td>
<td>$30,515</td>
</tr>
<tr>
<td>12</td>
<td>$1,057,331</td>
<td>31.5</td>
<td>$33,566</td>
</tr>
<tr>
<td>13</td>
<td>$1,126,142</td>
<td>30.5</td>
<td>$36,923</td>
</tr>
<tr>
<td>14</td>
<td>$1,198,141</td>
<td>29.5</td>
<td>$40,615</td>
</tr>
<tr>
<td>15</td>
<td>$1,273,279</td>
<td>28.5</td>
<td>$44,676</td>
</tr>
</tbody>
</table>

Table 12.6: Client Leaves $500,000 IRA to Grandchild

<table>
<thead>
<tr>
<th>Year</th>
<th>Pension Fund Beginning Value</th>
<th>Life Expectancy</th>
<th>Annual Distribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$500,000</td>
<td>71.7</td>
<td>$6,974</td>
</tr>
<tr>
<td>2</td>
<td>$542,329</td>
<td>70.7</td>
<td>$7,671</td>
</tr>
<tr>
<td>3</td>
<td>$588,124</td>
<td>69.7</td>
<td>$8,438</td>
</tr>
<tr>
<td>4</td>
<td>$637,655</td>
<td>68.7</td>
<td>$9,282</td>
</tr>
<tr>
<td>5</td>
<td>$691,210</td>
<td>67.7</td>
<td>$10,210</td>
</tr>
<tr>
<td>6</td>
<td>$749,101</td>
<td>66.7</td>
<td>$11,231</td>
</tr>
<tr>
<td>7</td>
<td>$811,657</td>
<td>65.7</td>
<td>$12,354</td>
</tr>
<tr>
<td>8</td>
<td>$879,233</td>
<td>64.7</td>
<td>$13,589</td>
</tr>
<tr>
<td>9</td>
<td>$952,208</td>
<td>63.7</td>
<td>$14,948</td>
</tr>
<tr>
<td>10</td>
<td>$1,030,985</td>
<td>62.7</td>
<td>$16,443</td>
</tr>
<tr>
<td>11</td>
<td>$1,115,997</td>
<td>61.7</td>
<td>$18,087</td>
</tr>
<tr>
<td>12</td>
<td>$1,207,700</td>
<td>60.7</td>
<td>$19,986</td>
</tr>
<tr>
<td>13</td>
<td>$1,306,584</td>
<td>59.7</td>
<td>$21,886</td>
</tr>
<tr>
<td>14</td>
<td>$1,413,168</td>
<td>58.7</td>
<td>$24,074</td>
</tr>
<tr>
<td>15</td>
<td>$1,528,003</td>
<td>57.7</td>
<td>$26,482</td>
</tr>
</tbody>
</table>
**Taxation of Traditional IRAs at Death**

At a participant’s death, a traditional IRA does not receive a step-up in basis. Distributions received after the participant’s death are income IRD and eventually will be taxed to the beneficiary.\(^\text{14}\) In designing an estate plan, care must be taken that income is not immediately recognized upon the death of the IRA holder. This can be done by proper beneficiary designation planning.

**IRC Section 691(c) Deduction (IRD)**

The person receiving income (the IRD) from an IRA can deduct the federal estate tax paid with respect to the IRA benefits.\(^\text{15}\) This is shown in the table 12.7, “Federal Estate Tax Deduction Resulting From an IRA.”

**Table 12.7: Federal Estate Tax Deduction Resulting From an IRA**

<table>
<thead>
<tr>
<th></th>
<th>Total Estate</th>
<th>Federal Estate Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>With IRA</td>
<td>$1,500,000</td>
<td>$289,350</td>
</tr>
<tr>
<td>Without IRA</td>
<td>$500,000</td>
<td>$0</td>
</tr>
<tr>
<td>IRC Section 691(c) Deduction</td>
<td></td>
<td>$289,350</td>
</tr>
</tbody>
</table>

In determining the value of this deduction, it is important to remember the following.

- The deduction is a miscellaneous itemized deduction but is not subject to the 2 percent floor.\(^\text{16}\)
- The deduction is likely, however, to be restricted by limitations on the amount of itemized deductions.
- The benefit of the IRD deduction is lost if no federal estate tax is paid on the taxable income (for example, in an optimal marital deduction plan).
- In a typical marital deduction estate plan, qualified plan and IRA proceeds should not be payable to *credit shelter* beneficiaries but rather should be paid to the marital deduction beneficiary, if possible. When the spouse or a marital trust receives the IRD and pays the income tax, the tax paid is

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\(^{14}\) IRC Section 691, GCM 39858.

\(^{15}\) IRC Section 691(c)(1).

\(^{16}\) IRC Section 67(b)(8).
effectively deducted from the spouse’s estate at the spouse’s death.

**Example:** John and Sue each have taxable estates. John leaves his $300,000 IRA to Sue and $1 million of other (non-IRD) assets to a credit shelter trust. Over Sue’s lifetime, she draws out the full $300,000 and pays federal and state income taxes of $100,000. At her death, only $200,000 remains ($300,000 IRA – $100,000 tax = $200,000) to be taxed in her estate, while the credit shelter trust remains $1 million. Conversely, if the $300,000 IRA had been paid to the credit shelter trust, the credit shelter trust would be reduced by the $100,000 of income taxes and Sue’s estate would have the full value of $300,000 of the other assets received from John’s estate.

**Additional Planning Points**

1. The IRD deduction under IRC Section 691(c) only applies to federal estate tax paid and does not give any benefit for state death taxes paid. On the other hand, if the surviving spouse pays both state and federal income tax on distributions received from the plan or IRA, the spouse’s estate effectively receives an estate tax deduction for the full amount of both income taxes, and so benefits from payment of both taxes.

2. The IRD deduction under IRC Section 691(c) applies only when a federal estate tax is incurred. This is why it is important to ensure that IRD passes at the second death, rather than at the first death, when the optimal marital deduction is used.

**Example:** Assume Brad and Stacey have $1,500,000, of which $600,000 is an IRA. The entire $600,000 passes to a trust for the benefit of their children at the first death. In this instance, no federal estate tax incurred. Correspondingly, at the second death, $900,000 passes to the children from Stacey’s estate with a federal estate tax being incurred. However, the $900,000 passing to the children at the second death would not contain the IRD associated with the qualified plan or IRA distribution. In the alternative, if $600,000 of hard assets are passed to the family trust at the first death, with the IRA balance passing at the second death, the IRD deduction is available for the $300,000 of IRA proceeds. (Based on the
assumption that both deaths occur in 2001.) This computation is shown in table 12.8. “Computation of Tax Benefit of Deduction.”

**Table 12.8: Computation of Tax Benefit of Deduction**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable estate</td>
<td>$900,000</td>
</tr>
<tr>
<td>Less IRD</td>
<td>(300,000)</td>
</tr>
<tr>
<td>Net estate without IRD</td>
<td>600,000</td>
</tr>
<tr>
<td>Federal estate tax attributable to IRD</td>
<td>86,400</td>
</tr>
<tr>
<td>equals income tax deduction</td>
<td></td>
</tr>
<tr>
<td>Tax benefit of deduction (at combined federal and state rate of 35 percent)</td>
<td>$30,240</td>
</tr>
</tbody>
</table>

A lifetime transfer of one spouse’s IRA to the other spouse’s IRA is a taxable distribution to the spouse from whose IRA the transfer was made and is not excludible from income as an interspousal transfer.17

**Prior Estate Tax Exemptions**

Retirement benefits, IRAs, and Roth IRAs are subject to estate tax in the participant’s estate.18 Prior law allowed a complete, and then a partial, estate tax exclusion for qualified plan assets if favorable income tax treatment was waived. Transition rules allow for the continuation of the exclusion in specified circumstances.19

### Disclaimer Provision and Beneficiary Designations

If a person makes a qualified disclaimer with respect to any interest in property, the interest is treated as never having been transferred to that person.20 For a qualified disclaimer to be effective, it must meet several requirements. The term *qualified disclaimer* is defined as an irrevocable and unqualified refusal by a person to accept an interest in property but only if—

- The refusal is in writing.

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17 IRC Section 1041. See Private Letter Ruling 9422060 (March 14, 1994).
18 IRC Section 2039(a).
19 See TEFRA Section 456(c), DEFRA Sec. 525(b), TRA ’86 Section 1852(e)(3). See also Private Letter Ruling 9211041 and Rev. Rul. 92-22, 1992-1 C.B. 313, for a discussion of the transition rules as they relate to qualified plans. The transition rules do not apply to the traditional or Roth IRAs (Rev. Rul. 92-22).
20 IRC Section 2518(a).
■ The writing is received by the transferor of the interest, a legal representative, or the holder of legal title to the property to which the interest relates within a specified time frame.
■ The person has not accepted the interest or any of its benefits.
■ As a result of the refusal, the interest passes without any direction on the part of the person making the disclaimer and passes either to the spouse of the decedent or to a person other than the person making the disclaimer.21

If all of the preceding requirements are met, the disclaimer is a qualified disclaimer within IRC Section 2518.

A few other issues need to be addressed when reviewing qualified disclaimers under IRC Section 2518. The first is whether a disclaimer of benefits under a qualified plan constitutes either an assignment or alienation of plan benefits contrary to IRC Section 401(a)(13) and ERISA Section 206(d), or an assignment of income. GCM 39858 states that a disclaimer of qualified plan benefits that satisfies the requirements of state law and IRC Section 2518(b) is neither a prohibited assignment or alienation nor an assignment of income.

Another issue is whether a disclaimer of benefits from either an IRA or an individual retirement annuity constitutes an assignment of income and whether a disclaimer is contrary to IRC Section 408(a)(4) or IRC Section 408(b)(1). IRC Section 408(a)(4) and IRC Section 408(b)(1) address the nonforfeit ability and nontransferability of IRAs or individual retirement annuities. GCM 39858 concludes that a disclaimer of benefits from an IRA that satisfies the requirements of state law and IRC Section 2518(b) is not an assignment of income. Also, the disclaimer is not contrary to IRC Section 408(a)(4) and IRC Section 408(b)(1).22

The Importance of Having a Designated Beneficiary

To maximize the tax deferral of any IRA, it is important to choose the proper designated beneficiary. This choice will significantly affect the calculation of the RMDs and will therefore determine the amount of tax deferral that will ultimately be available. In making this choice, it is very important that the tax regulations are closely followed. Recent changes in these regulations will allow taxpayers certain new advantages in their

21 IRC Section 2518(b).
planning including greater flexibility in naming a beneficiary or beneficiaries. To understand the significance of these changes, it is important to understand the consequences of naming the incorrect beneficiary or combination of beneficiaries under the 1997 regulations.

**Distributions After the Death of the Owner Without a Designated Beneficiary**

If the owner of a qualified plan or ordinary IRA does not have a designated beneficiary and the owner dies before his or her required beginning date, the IRC dictates that the qualified plan or IRA must be distributed by December 31 of the year containing the fifth anniversary of the death of the owner.\(^2\) The distribution can be made in any fashion the beneficiary chooses. It may be made ratably over this period of time or in a lump sum on December 30 of the year containing the fifth anniversary of the death of the IRA owner. This relatively rapid withdrawal may cause the beneficiaries of the IRA to lose many years of deferral.

If the owner of a qualified plan or ordinary IRA dies after his or her required beginning date and does not have a designated beneficiary, the consequences were once tragic. Under the old regulations, the IRA must have been distributed by December 31 of the year after death.\(^2\) For many families this would have a devastating effect on the wealth transfer to future generations.

Under the new regulations, however, if the owner of a qualified plan or ordinary IRA dies after his or her required beginning date and does not have a designated beneficiary, distributions are taken out by referencing the decedent’s age in the year of death to the table in Treas. Reg. 1.72-9 and reducing one for any year thereafter.\(^2\)

**Death Before Required Beginning Date**

The IRC allows a designated beneficiary to receive distributions over his or her single-life expectancy if the distributions begin by December 31 of the year following death.\(^2\) This is usually far more advantageous than the five-year rule discussed above for death before the required beginning date if there is no designated beneficiary. Therefore, having a designated

\(^2\) IRC Section 401(a)(9)(B)(ii).
\(^2\) IRC Section 401(a)(9)(B)(i).
\(^2\) IRC Section 401(a)(9)(B)(iii).
beneficiary is critical to preserve the deferral that can be achieved with proper planning.

If a qualified disclaimer under IRC Section 2518 and relevant state law is executed by a spouse, he or she is assumed to have predeceased the participant. When a disclaimer by the spouse results in transfer to the family trust, the oldest beneficiary of the trust is treated as the designated beneficiary for purposes of determining distributions assuming the family trust meets the requirements of a designated beneficiary.

Death After the Required Beginning Date

If the participant has a designated beneficiary and dies after the required beginning date, the IRC states that the remaining portion of the IRA must be distributed at least as rapidly as before.\(^{27}\)

For individuals who die after their required beginning date and have a qualified beneficiary as of December 31 of the year following the year of death, distributions are determined based upon the beneficiary’s life expectancy as referenced in Treas. Reg. 1.72-9, Table V. For each succeeding year, this factor is reduced by one.\(^{28}\)

Similar provisions apply if the participant dies after the required beginning date and the primary beneficiary, the spouse, disclaims a portion resulting in transfer to the family trust. Because the family trust will be a beneficiary as of December 31 of the year following the year of death, the distributions after the death of the participant are determined based on the oldest trust beneficiary’s life expectancy. If separate shares are created for each trust beneficiary by December 31 of the year following the year of death, each beneficiary can use his or her own individual life expectancy to determine RMDs. Again, for this trust to be a designated beneficiary, certain requirements must be met. If the trust is not a qualified trust for purposes of Reg. Sec. 1.401(a)(9)-4 A-5 and A-6, and the owner dies after his required beginning date, the IRA must be distributed based upon the owner’s life expectancy in the year of death.

In summary, if a qualified disclaimer is exercised, the disclaiming party, in this case the spouse, is treated as having predeceased the participant. Therefore, if the family trust is named as the contingent beneficiary, the family trust is treated as a designated beneficiary if the trust meets all of the

\(^{27}\) IRC Section 401(a)(9)(B)(I).

\(^{28}\) Prop. Treas. Reg. Sec. 1.401(a)(9)-5 Q&A 5(c)(1).
requirements set forth above and distributions from the IRA are determined on the oldest trust beneficiary’s life expectancy. If the trust is not a qualified trust under IRC Section 401(a)(9), the distribution is determined depending on whether the participant died before or after the required beginning date.

**Drafting the Disclaimer**

Care must be taken when drafting a disclaimer. It is a legal document and should be drafted in collaboration with the client’s attorney. A disclaimer should not refer to a pecuniary amount that passes to the trust (that is, the amount that results in no federal estate tax). If a pecuniary amount is used to fund the trust, the income in respect of a decedent (IRD) is accelerated and income tax is due on the entire amount disclaimed (or pecuniary amount). Furthermore, the disclaimer must be coordinated with the funding clause in the revocable trust or will.

---

**Distributions After Death**

Postmortem distributions from both the traditional and the Roth IRA are driven by the IRC Section 401(a)(9) rules. For a traditional IRA, if your client names his or her spouse as the primary beneficiary, at your client’s death (when survived by the spouse), distributions from the traditional IRA are shown in Table 12.9, “Naming Spouse as the Designated Beneficiary—Inherited Treatment After the Death of a Participant,” which assumes the spouse (age 74) does not roll over the IRA.

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**Postmortem Distributions From a Roth IRA**

IRC Section 408A(c)(4) provides that the distribution rules of IRC Section 401(a)(9)(A) do not apply before death. In the event of a nonspousal beneficiary, distributions can be made over the beneficiary’s life expectancy by referencing Table V of Treas. Reg. Sec. 1.72-9. These distributions provide a potential for deferral.

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29 See IRC Section 691(a).
TABLE 12.9: NAMING SPOUSE AS THE DESIGNATED BENEFICIARY—INHERITED TREATMENT AFTER THE DEATH OF A PARTICIPANT

<table>
<thead>
<tr>
<th>Year</th>
<th>Begin Pension Fund Balance</th>
<th>Life Expectancy</th>
<th>Annual Distribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>$1,000,000</td>
<td>13.2</td>
<td>$75,758</td>
</tr>
<tr>
<td>2002</td>
<td>$1,016,666</td>
<td>12.5</td>
<td>$81,333</td>
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<tr>
<td>2003</td>
<td>$1,028,866</td>
<td>11.9</td>
<td>$86,459</td>
</tr>
<tr>
<td>2004</td>
<td>$1,036,666</td>
<td>11.2</td>
<td>$92,558</td>
</tr>
<tr>
<td>2005</td>
<td>$1,038,499</td>
<td>10.6</td>
<td>$97,972</td>
</tr>
<tr>
<td>2006</td>
<td>$1,034,580</td>
<td>10.0</td>
<td>$103,458</td>
</tr>
<tr>
<td>2007</td>
<td>$1,024,234</td>
<td>9.5</td>
<td>$107,814</td>
</tr>
<tr>
<td>2008</td>
<td>$1,008,062</td>
<td>8.9</td>
<td>$113,265</td>
</tr>
<tr>
<td>2009</td>
<td>$984,277</td>
<td>8.4</td>
<td>$117,176</td>
</tr>
<tr>
<td>2010</td>
<td>$953,811</td>
<td>7.9</td>
<td>$120,736</td>
</tr>
<tr>
<td>2011</td>
<td>$916,383</td>
<td>7.4</td>
<td>$123,836</td>
</tr>
</tbody>
</table>

SPOUSAL DISTRIBUTIONS

At the death of a Roth IRA holder, his or her spouse has two distinct choices. The surviving spouse can—

1. Roll over the Roth IRA into his or her own name.
2. Receive the Roth IRA as an inherited IRA with distributions beginning no later than the year in which the deceased spouse would have turned age 70 1/2, if death has not occurred.

The spouse, of course, may also disclaim the Roth IRA in favor of a bypass trust or the contingent beneficiaries. This has the advantage of saving estate tax while allowing the spouse to continue as a beneficiary of the trust. (See chapter 11, "Tax Planning at the Death of the First Spouse.")

SPOUSAL ROLLOVERS

At the death of a Roth IRA holder, the surviving spouse is allowed to roll over the Roth IRA into his or her own Roth IRA. Furthermore, the surviving spouse is allowed to roll over the decedent spouse's traditional

---

30 At the surviving spouse's death, the first distribution is determined based upon the spouse's attained age in the year of death by reference to Table V of Treas. Reg. Sec. 1.72-9. For each succeeding year, this process is repeated.

31 The life expectancy of the surviving spouse is the surviving spouse's life expectancy at age 74.
IRA into the surviving spouse’s traditional IRA and subsequently make a Roth IRA conversion election.

**Traditional IRA-to-Roth IRA Rollover**

Similar to the traditional IRA-to-traditional IRA rollover, IRC Section 408 governs Roth IRA-to-Roth IRA rollovers. Based on the current state of private letter rulings in the area, it appears that IRA-to-IRA rollovers are permitted even after age 70 1/2. There is very little doubt that spousal rollovers are permitted before age 70 1/2. Further, the fact that spousal rollovers are permitted after the required beginning date appears to be clearly established.

In the context of both the traditional and, presumably, the Roth IRA, rollovers from estates and revocable trusts may be allowed in limited circumstances. When a surviving spouse is a beneficiary of an estate or revocable trust, rollovers should be permitted. When the surviving spouse is the beneficiary of a marital trust (under a revocable trust) and there is a specific transfer of IRA assets, it appears likely that a rollover may also be permitted (Private Letter Rulings 8920045 and 9235058). In addition, a recent Private Letter Ruling clarified that post-death distributions from an inherited IRA do not preclude a spousal rollover. The regulations state that the spouse must be the sole beneficiary of the IRA and have an unlimited right to make withdrawals from the IRA. Presumably, the same provisions apply for the Roth IRA.

**The Inherited IRA Concept**

Perhaps the most powerful planning strategy involving both the traditional and the Roth IRA is the inherited IRA concept. For many families whose assets are substantial, the inherited IRA concept represents the best chance of transferring retirement wealth to their children through the following steps.

- The IRA is payable to one’s spouse.

---

32 See Private Letter Rulings 9311037, 9433031, and 960034.
33 See Private Letter Rulings 8746055, 9520420, and 200027061.
34 Private Letter Ruling 20011033.
36 IRC Section 408A(a) provides that the same provisions that govern traditional IRAs also apply to Roth IRAs.
Plan distributions are used to fund a life insurance policy.
A second-to-die life insurance policy is purchased and held in an irrevocable life insurance trust.
A spousal rollover is performed.
The spouse names children IRA beneficiaries.
The spouse has proper tax-apportionment clauses.
The children use life insurance to pay any estate tax liability.
The children enjoy distributions over their life expectancy.

When 100 percent of the IRAs need to be used to fund the bypass trust, the inherited IRA may not be desirable. When this occurs, a surviving spouse should disclaim any interest in the bypass trust.

STATE-OF-THE-ART RECOMMENDATIONS FOR THE TRADITIONAL IRA

For many years, the traditional IRA has represented the most complex portion of the modern estate plan. Planners throughout the country struggle with how to best integrate the IRA into planning for a surviving spouse and planning to fund the unified credit trust. The increase in the unified credit from $675,000 to $1 million in 2002 will add additional complexity to this area.

Transfers to the surviving spouse are relatively easy. In many estate plans, the surviving spouse simply is the primary beneficiary, with the intention that the surviving spouse rolls over the funds into his or her own name. Transfers to the surviving spouse generally qualify for the estate tax marital deduction, and no estate tax will be due until the surviving spouse’s death. Transfers to a nonspousal beneficiary or to a trust require more involved planning. A series of private rulings indicates that at the death of the first spouse, the second spouse has the right to roll over the decedent spouse’s IRA into his or her own IRA.\textsuperscript{37}

\textbf{Example:} Jim dies at age 65, naming his wife Margaret the beneficiary of his IRA. Subsequent to Jim’s death, Margaret has the option of rolling Jim’s IRA into an IRA in her own name. Once the IRA is rolled into Margaret’s name, Margaret will have the ability to name new beneficiaries.

\textsuperscript{37} Generally, Private Letter Rulings 200052045, 200106047, and 200110033.
Later, at Margaret’s death, distributions are made over the beneficiaries’ life expectancy.

Basically, the following nine planning strategies are useful to fund the bypass trust:

1. A direct payment to a testamentary trust
2. Direct payment to both a testamentary trust and spouse using a fractional funding clause
3. Disclaimer to a testamentary trust
4. Direct payment to a revocable trust
5. Disclaimer to a revocable trust
6. Direct payment to an irrevocable IRA trust
7. Disclaimer to an irrevocable IRA bypass trust
8. Direct payment to a QTIP trust later followed by a partial QTIP election
9. Disclaimer to a QTIP trust later followed by a partial QTIP election

As if the preceding is not complex enough, you should remember that fractional funding clauses must be used when passing the IRA to a bypass trust. Many wills and estate plans use a pecuniary funding clause, and when a pecuniary clause is used to transfer IRD, the income will be accelerated.\(^{38}\)

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**FUNDING THE BYPASS TRUST WITH THE ROTH IRA**

Clients will now ask, “Should I use my traditional IRA or my Roth IRA to fund my bypass trust?” At first, this may seem like a difficult question; however, it may be relatively straightforward. Income tax has already been paid on the Roth IRA. If $1 million of Roth IRA assets\(^ {39} \) are used to fund a bypass trust, this may actually result in a greater wealth transfer than $1 million of traditional IRA assets. This is shown in Table 12.10, “Value of Assets Passing to the Bypass Trust.”

\(^{38}\) IRC Section 691(a)(1). An example of a pecuniary funding clause is the amount that results in no federal estate tax.

\(^{39}\) 2002 unified credit exemption amount.
TABLE 12.10: VALUE OF ASSETS PASSING TO THE BYPASS TRUST

<table>
<thead>
<tr>
<th></th>
<th>Traditional IRA</th>
<th>Roth IRA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exemption amount</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Less income taxes at 31 percent</td>
<td>310,000</td>
<td>0</td>
</tr>
<tr>
<td>Net to family</td>
<td>$690,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Additional wealth transfer</td>
<td>$310,000</td>
<td></td>
</tr>
</tbody>
</table>

Income taxes severely affect the amount of wealth that actually transfers to the bypass trust. In the instance above, only $690,000 out of the original $1 million survives the income tax system to pass to the family. In the alternative, if the Roth IRA is used, greater distributions occur.

***

NAMING THE CHILDREN BENEFICIARIES

In the context of a traditional IRA, it may be advisable in certain circumstances to name a child or children the beneficiaries of a taxpayer’s IRA. By naming the children the direct beneficiary of the IRA, a taxpayer guarantees deferral over a child’s life expectancy. The taxpayer could achieve the same result by naming his or her spouse as the designated beneficiary of his or her IRA if the taxpayer were to die first, his or her spouse could roll over the IRA and subsequently name the children as the beneficiaries. In situations in which a taxpayer and his or her spouse do not need the money from a rollover IRA, consideration should be given to naming the children the direct beneficiaries of his or her IRA. Naming the spouse as beneficiary, however, allows for greater post-death planning flexibility (meaning, disclaimer by spouse). With both a traditional and Roth IRA, a taxpayer can change his or her beneficiary up until their death.

***

CREDITOR PROTECTION

Before converting to a Roth IRA, the practitioner would be well advised to look at the state statutes for creditor protection. By now, most states have the same protection for a Roth IRA as a traditional IRA, however, there may be some states that do not allow the same creditor protection.
for Roth IRAs. In circumstances in which a state does not have the same creditor protection for Roth IRAs as for traditional IRAs, the client should be notified of this adverse consequence and if this consequence is significant a Roth IRA conversion should not be made.
Naming a Trust

Beneficiary of an IRA

chapter XIII
INTRODUCTION

One of the most complicated areas of the tax law are the rules that address naming a trust as a designated beneficiary of an individual retirement account (IRA). In the typical situation, if an IRA owner does not have enough assets to fund his or her credit shelter trust, they may need to name the credit shelter trust as the beneficiary of the IRA. In these instances, the owner must follow specific guidelines with regard to naming a trust the designated beneficiary, and the trust must meet specific requirements to be a qualified trust. The remainder of this chapter discusses the distribution rules and the qualification rules of trusts that are named the beneficiary of an IRA.

THE IMPORTANCE OF HAVING A "DESIGNATED BENEFICIARY"

To maximize the tax deferral of any IRA, it is important to chose the proper designated beneficiary. This choice will significantly affect the calculation of the required minimum distributions (RMDs) and will therefore determine the amount of tax deferral that will ultimately be available. In making this choice, it is very important that the tax regulations are closely followed. Recent changes in these regulations will allow taxpayers certain new advantages in their planning, including the greater flexibility as to when they can name a beneficiary. To understand the significance of these changes, it is important to understand the consequences of this planning choice under the proposed regulations, and the rules that now apply.

DISTRIBUTIONS AFTER THE DEATH OF THE OWNER WITHOUT A DESIGNATED BENEFICIARY

If the owner of a qualified plan or ordinary IRA does not have a designated beneficiary and the owner dies before the required beginning date, the Internal Revenue Code (IRC) dictates that the qualified plan or IRA must be distributed by December 31 of the year containing the fifth anniversary of the death of the owner. The distribution can be made in any fashion the beneficiary chooses. It may be made ratably over this period of time or in a lump sum on December 30 of the year containing the fifth anniversary.
of the death of the IRA owner. This relatively rapid withdrawal may cause the beneficiaries of the IRA to lose many years of deferral.

In the past, if the owner of a qualified plan or ordinary IRA dies after his or her required beginning date and does not have a designated beneficiary, the consequences were tragic. Under the old regulations, the IRA must have been distributed by December 31 of the year after death.¹ For many families, this would have a devastating effect on the wealth transfer to future generations.

Under the new regulations, however, if the owner of a qualified plan or ordinary IRA dies after his or her required beginning date and does not have a designated beneficiary by December 31 of the year following the year of death, distributions are taken out by referencing the owner’s age in the year of death to the table in Treas. Reg. 1.72-9 and reducing one for any year thereafter.²

### DISTRIBUTIONS AFTER THE DEATH OF THE OWNER WITH A DESIGNATED BENEFICIARY

The IRC allows a designated beneficiary to receive distributions over his or her single-life expectancy if the distributions begin by December 31 of the year following death.³ This is usually far more advantageous than the five-year rule discussed above for death before the required beginning date if there is no designated beneficiary. Therefore, having a designated beneficiary is critical to preserve the deferral that can be achieved with proper planning.

If the participant has a designated beneficiary and dies after the required beginning date, the IRC states that the remaining portion of the IRA must be distributed at least as rapidly as before.⁴

For individuals who die after their required beginning date and have a qualified beneficiary as of December 31 of the year following the year of death, distributions are determined based upon the beneficiary’s life expectancy as referenced in Treas. Reg. 1.72-9 Table V. For each succeeding year, this factor is reduced by one.

¹ IRC Section 401(a)(9)(B)(I).
³ IRC Section 401(a)(9)(B)(ii).
⁴ IRC Section 401(a)(9)(B)(i).
TRUSTS AS DESIGNATED BENEFICIARY OF AN IRA

It is clearly very important that IRAs have proper designated beneficiaries to allow the most favorable tax deferral.

A designated beneficiary is defined as any individual who is designated by the owner of the qualified plan or IRA. However, trusts can qualify as a designated beneficiary if the trusts meet certain criteria found in the regulations.

Under both the 1997 and 2001 proposed regulations, a trust qualifies as a designated beneficiary if it is revocable while the individual is alive, provided that it becomes irrevocable upon the individual's death. Therefore, the new proposed regulations will allow a person to name a Revocable Living Trust as a designated beneficiary of the person's IRA if, by its terms, the trust could become irrevocable at the person's death.

The specific amendment to Prop. Regs. Sec. 1.401(a)(9)-1 Q&A 5(a) states that in order for a trust to be a designated beneficiary the following requirements must be met.

1. The trust is a valid trust under state law, or would be but for the fact that there is no corpus.
2. The trust is irrevocable or will, by its terms, become irrevocable upon the death of the participant.
3. The beneficiaries of the trust who are beneficiaries with respect to the trust's interest in the participant's benefit are identifiable from the trust instrument.
4. The documentation required has been provided to the plan administrator.

In addition, this new regulation creates deadlines as to when documentation must be provided to the plan administrator when a trust is named as the designated beneficiary. The following is an outline of what must be submitted to the plan administrator:

When the participant reaches his or her required beginning date, the participant must do either of the following.

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5 Special care should be taken when naming a revocable trust as the beneficiary of an IRA that splits the estate into two trusts. The funding clause of this type of trust should fund family and marital trusts with a fractional funding clause. A pecuniary clause would accelerate recognition of income because the IRA is income in respect of a decedent. See IRC Sec. 691(a).
6 Prop. Treas. Reg. Sec. 1.401(a)(9)-4 Q&A 6(a) and (b).
1. Provide the plan administrator with a copy of the trust instrument and agree that if the trust instrument is amended at any time in the future, the participant will, within a reasonable time, provide a copy of the amendment to the plan administrator.

2. Provide the plan administrator with a list of all the beneficiaries (including contingent and remainderman beneficiaries with a description of the conditions on their entitlement) of the trust, certify to the best of the participant’s knowledge that this list is correct and complete and that the specific requirements of the trust are met, agree to provide corrected certifications to the extent that there are any amendments or changes to the information previously submitted, and agree to provide a copy of the trust instrument to the plan administrator upon demand.

In order to satisfy the documentation requirement after the death of the participant, by December 31 of the year after the year of the death of the participant, the trustee must do the following.

1. Provide the plan administrator with a final list of all beneficiaries (including contingent and remainderman beneficiaries with a description of the conditions on their entitlement) of the trust as of the date of death, certify that to the best of the trustee’s knowledge this list is correct and complete, and agree to provide a copy of the trust instrument to the plan administrator upon demand.

2. Provide the plan administrator with a copy of the actual trust document for the trust that was named as a beneficiary as of the participant’s date of death.

*Note:* A qualified designated beneficiary cannot be an estate, a charity, a trust with a charity as a beneficiary of the trust, or a trust that does not meet the requirements described above. However, if that is the situation, there may be an outside opportunity to assign or cash out of the interest from the trust to a nonqualified beneficiary. If this is accomplished prior to December 31 of the year following death, an argument can be made for the use of the remaining qualified beneficiary’s life expectancies.

Unless there is an estate planning reason (meaning, the credit shelter needs to be funded with IRA assets), naming a credit shelter trust may not be
Naming a Trust Beneficiary of an IRA

advisable. In the typical situation, the taxpayer’s spouse will be the oldest beneficiary and, therefore, distributions will have to be calculated based on his or her life expectancy. The better choice of beneficiaries may be the children made either through a spousal disclaimer or by naming them directly. The additional deferral that can be achieved is illustrated in Table 13.1, “Traditional IRA Designated Beneficiaries.”

**Table 13.1: Traditional IRA Designated Beneficiaries**

<table>
<thead>
<tr>
<th>Year</th>
<th>Beginning Balance</th>
<th>Life Expectancy</th>
<th>Required Minimum Distribution</th>
<th>Beginning Balance</th>
<th>Life Expectancy</th>
<th>Required Minimum Distribution</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$500,000</td>
<td>11.0</td>
<td>$45,455</td>
<td>$500,000</td>
<td>32.7</td>
<td>$15,291</td>
</tr>
<tr>
<td>1</td>
<td>$500,000</td>
<td>10.0</td>
<td>$50,000</td>
<td>$533,180</td>
<td>31.7</td>
<td>$16,820</td>
</tr>
<tr>
<td>2</td>
<td>$495,000</td>
<td>9.0</td>
<td>$55,000</td>
<td>$567,996</td>
<td>30.7</td>
<td>$18,501</td>
</tr>
<tr>
<td>3</td>
<td>$484,000</td>
<td>8.0</td>
<td>$60,500</td>
<td>$604,445</td>
<td>29.7</td>
<td>$20,352</td>
</tr>
<tr>
<td>4</td>
<td>$465,850</td>
<td>7.0</td>
<td>$66,550</td>
<td>$642,502</td>
<td>28.7</td>
<td>$22,387</td>
</tr>
<tr>
<td>5</td>
<td>$439,230</td>
<td>6.0</td>
<td>$73,205</td>
<td>$682,127</td>
<td>27.7</td>
<td>$24,626</td>
</tr>
<tr>
<td>6</td>
<td>$402,628</td>
<td>5.0</td>
<td>$80,526</td>
<td>$723,251</td>
<td>26.7</td>
<td>$27,088</td>
</tr>
<tr>
<td>7</td>
<td>$354,312</td>
<td>4.0</td>
<td>$88,578</td>
<td>$765,779</td>
<td>25.7</td>
<td>$29,797</td>
</tr>
<tr>
<td>8</td>
<td>$292,307</td>
<td>3.0</td>
<td>$97,436</td>
<td>$809,580</td>
<td>24.7</td>
<td>$32,777</td>
</tr>
<tr>
<td>9</td>
<td>$214,358</td>
<td>2.0</td>
<td>$107,179</td>
<td>$854,483</td>
<td>23.7</td>
<td>$36,054</td>
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<tr>
<td>10</td>
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<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Figure 13.1, “Trust as the Designated Beneficiary of an IRA,” illustrates the typical operation of naming a credit shelter trust the designated beneficiary of an IRA.
Figure 13.1: Trust as the Designated Beneficiary of an IRA

Trust as the Designated Beneficiary of an IRA

Distributions will be made over the oldest beneficiary’s life expectancy (i.e. spouse).
The Roth Legacy Trust

Chapter XIV
The Roth Legacy Trust promises to be an exciting wealth transfer planning vehicle available to many individual retirement account (IRA) holders. Since the Taxpayer Relief Act of 1997 (the 1997 Act), much has been written about the advantages of the Roth IRA. Included in these advantages is the ability to defer distributions after age 70 1/2. It is important to understand the advantages of the Roth IRA before discussing the potential available through a Roth Legacy Trust to stretch the required distributions over a lengthier time frame.

**REQUIRED BEGINNING DATE PLANNING**

At age 70 1/2, one does not need to take distributions from his or her Roth IRA. Rather than taking funds from the Roth IRA and reinvesting them in an investment account, one can simply continue the deferral within the Roth IRA. The chart below shows the value of this deferral beyond the required beginning date. If the IRA is a traditional IRA, the owner must begin taking minimum distributions. This is illustrated in the three columns under the heading "Traditional IRA." The required minimum distribution (RMD) is invested, after-tax (30-percent tax rate), in an outside account that earns 10 percent. It is also assumed that the outside account growth is taxed at 30 percent. In contrast, the Roth IRA is not subject to minimum distributions during the IRA owner’s lifetime. Therefore, the $500,000 beginning balance will continue to grow tax-free until the account owner’s death. This is shown in Table 14.1, "Comparison of Traditional and Roth IRA Distributions," in the three columns under the heading "Roth IRA."

One of the key advantages of both ordinary IRAs and Roth IRAs is the ability to stretch an IRA over the life expectancy of the designated beneficiary. The greatest wealth transfer will generally coincide with the longest deferral period.

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1 The Roth Legacy Trust is a Service Mark of Virchow, Krause & Company, LLP.

2 IRC Section 408A(c)(5).
**Table 14.1: Comparison of Traditional and Roth IRA Distributions**

<table>
<thead>
<tr>
<th>Year</th>
<th>Traditional IRA</th>
<th></th>
<th>Roth IRA</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$500,000</td>
<td>$24,272</td>
<td>$541,481</td>
<td>$500,000</td>
</tr>
<tr>
<td>2</td>
<td>$523,301</td>
<td>$26,699</td>
<td>$585,712</td>
<td>$550,000</td>
</tr>
<tr>
<td>3</td>
<td>$546,262</td>
<td>$29,369</td>
<td>$632,791</td>
<td>$605,000</td>
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<tr>
<td>4</td>
<td>$568,583</td>
<td>$32,036</td>
<td>$682,805</td>
<td>$665,500</td>
</tr>
<tr>
<td>5</td>
<td>$609,805</td>
<td>$35,536</td>
<td>$735,825</td>
<td>$732,050</td>
</tr>
<tr>
<td>6</td>
<td>$643,266</td>
<td>$39,090</td>
<td>$791,906</td>
<td>$805,255</td>
</tr>
<tr>
<td>7</td>
<td>$663,888</td>
<td>$42,299</td>
<td>$851,080</td>
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<td>$688,307</td>
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<tr>
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<td>$713,982</td>
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<td>$978,691</td>
<td>$1,071,794</td>
</tr>
<tr>
<td>10</td>
<td>$740,870</td>
<td>$53,532</td>
<td>$1,047,028</td>
<td>$1,178,974</td>
</tr>
</tbody>
</table>

*Example: Mr. Jones dies at age 69, with his only child, age 47, as the primary beneficiary of his IRA. The tax law provides that the designated beneficiary shall have the right to take distributions over his life expectancy rather than an immediate lump-sum distribution. This is shown in table 14.2, “Traditional IRA Analysis—Post-Death Situation.”

**Table 14.2: Traditional IRA Analysis—Post-Death Situation**

<table>
<thead>
<tr>
<th>Year</th>
<th>Beginning IRA Balance</th>
<th>Required Minimum Distribution</th>
<th>Taxes at 36%</th>
<th>Beginning Outside Balance</th>
<th>Growth at 10%</th>
<th>Taxes at 20%</th>
<th>Ending Outside Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$600,000</td>
<td>$16,713</td>
<td>($6,017)</td>
<td>$10,696</td>
<td>$1,070</td>
<td>($214)</td>
<td>$11,552</td>
</tr>
<tr>
<td>2</td>
<td>$641,616</td>
<td>$18,384</td>
<td>($6,618)</td>
<td>$23,318</td>
<td>$2,332</td>
<td>($466)</td>
<td>$25,184</td>
</tr>
<tr>
<td>3</td>
<td>$685,554</td>
<td>$20,223</td>
<td>($7,280)</td>
<td>$38,126</td>
<td>$3,813</td>
<td>($763)</td>
<td>$41,176</td>
</tr>
<tr>
<td>4</td>
<td>$731,865</td>
<td>$22,245</td>
<td>($8,008)</td>
<td>$55,413</td>
<td>$5,541</td>
<td>($1,108)</td>
<td>$59,846</td>
</tr>
<tr>
<td>5</td>
<td>$780,581</td>
<td>$24,470</td>
<td>($8,809)</td>
<td>$75,507</td>
<td>$7,551</td>
<td>($1,510)</td>
<td>$81,547</td>
</tr>
<tr>
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<td>$831,723</td>
<td>$26,917</td>
<td>($9,690)</td>
<td>$98,774</td>
<td>$9,877</td>
<td>($1,975)</td>
<td>$106,676</td>
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<td>$885,287</td>
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<td>$125,625</td>
<td>$12,563</td>
<td>($2,513)</td>
<td>$135,675</td>
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<td>$15,652</td>
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<td>$39,409</td>
<td>($14,187)</td>
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<td>$23,255</td>
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<td>$251,153</td>
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<td>($15,606)</td>
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<td>$27,890</td>
<td>($5,578)</td>
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<tr>
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<td>$358,264</td>
</tr>
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<td>$391,834</td>
<td>$39,183</td>
<td>($7,837)</td>
<td>$423,180</td>
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<td>$46,011</td>
<td>($9,202)</td>
<td>$496,916</td>
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<td>$63,468</td>
<td>($22,848)</td>
<td>$537,535</td>
<td>$53,754</td>
<td>($10,751)</td>
<td>$580,538</td>
</tr>
</tbody>
</table>

*Assumes a $600,000 beginning IRA balance. The beneficiary has a 35.9-year single-life expectancy, since he is age 47.
Example: Consider the same facts as the preceding example, except now, the IRA is a Roth IRA. This is shown in table 14.3, “Roth IRA Analysis—Post-Death Situation.”

<table>
<thead>
<tr>
<th>Year</th>
<th>Beginning Roth IRA Balance</th>
<th>Required Minimum Distribution</th>
<th>Taxes at 0%</th>
<th>Beginning Outside Balance</th>
<th>Growth at 10%</th>
<th>Taxes at 20%</th>
<th>Ending Outside Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$600,000</td>
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<td>$16,713</td>
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<td>$18,050</td>
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<td>$641,616</td>
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<td>$0</td>
<td>$36,435</td>
<td>$3,643</td>
<td>($729)</td>
<td>$39,349</td>
</tr>
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<td>$685,554</td>
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<td>$0</td>
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<td>$5,957</td>
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<td>$64,338</td>
</tr>
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<td>$86,583</td>
<td>$8,658</td>
<td>($1,732)</td>
<td>$93,510</td>
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<td>$0</td>
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<td>$11,798</td>
<td>($2,360)</td>
<td>$127,418</td>
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<tr>
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<td>$831,723</td>
<td>$26,917</td>
<td>$0</td>
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<td>$15,433</td>
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<td>$0</td>
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<td>$211,992</td>
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<td>$24,456</td>
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<tr>
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<td>$299,952</td>
<td>$29,995</td>
<td>($5,999)</td>
<td>$323,949</td>
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<tr>
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<td>$36,336</td>
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<td>$61,224</td>
<td>($12,245)</td>
<td>$661,219</td>
</tr>
<tr>
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<td>$0</td>
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<td>$71,892</td>
<td>($14,378)</td>
<td>$776,431</td>
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<tr>
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<td>$839,899</td>
<td>$83,990</td>
<td>($16,798)</td>
<td>$907,091</td>
</tr>
</tbody>
</table>

*Assumes a $600,000 beginning IRA balance. The beneficiary has a 35.9-year single-life expectancy, since he is age 47. No income tax is due on the RMD because of the Roth IRA.

The key difference between these scenarios is that the Roth IRA is tax-exempt. In both of these scenarios, the child is the direct beneficiary of the ordinary and/or Roth IRA.

There are at least the following four disadvantages of having a child as a direct IRA beneficiary.

1. The child may accelerate IRA distributions, thus negating the benefit of deferral.

The advantage of deferral is shown in table 14.4, “Comparison of Roth IRA Withdrawals.”

2. A financially unsophisticated child may not obtain proper investment counsel. Table 14.5, “Comparisons of Returns of Roth IRAs,” illustrates the benefit of higher returns in a Roth IRA.

3. The Inherited or Roth IRA may (in some states) be subject to the claims of creditors; or in a less common situation, the claims of one’s spouse.
### Table 14.4: Comparison of Roth IRA Withdrawals

<table>
<thead>
<tr>
<th>Year</th>
<th>Beginning Roth IRA Balance</th>
<th>Ending Roth IRA Balance</th>
<th>Required Minimum Distribution</th>
<th>Ending Roth IRA and Outside Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
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<td>$535,000</td>
<td>$11,765</td>
<td>$549,647</td>
</tr>
<tr>
<td>2</td>
<td>$0</td>
<td>$572,450</td>
<td>$12,941</td>
<td>$603,846</td>
</tr>
<tr>
<td>3</td>
<td>$0</td>
<td>$612,522</td>
<td>$14,235</td>
<td>$662,984</td>
</tr>
<tr>
<td>4</td>
<td>$0</td>
<td>$655,398</td>
<td>$15,659</td>
<td>$727,479</td>
</tr>
<tr>
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<td>$701,276</td>
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<td>$797,780</td>
</tr>
<tr>
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<td>$0</td>
<td>$750,365</td>
<td>$18,947</td>
<td>$874,372</td>
</tr>
<tr>
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<td>$0</td>
<td>$802,891</td>
<td>$20,842</td>
<td>$957,774</td>
</tr>
<tr>
<td>8</td>
<td>$0</td>
<td>$859,093</td>
<td>$22,926</td>
<td>$1,048,547</td>
</tr>
<tr>
<td>9</td>
<td>$0</td>
<td>$919,230</td>
<td>$25,219</td>
<td>$1,147,290</td>
</tr>
<tr>
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<td>$1,254,648</td>
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<td>$1,635,551</td>
</tr>
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<td>$1,289,267</td>
<td>$40,615</td>
<td>$1,784,766</td>
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<td>$1,379,516</td>
<td>$44,676</td>
<td>$1,946,557</td>
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<td>$2,121,886</td>
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<td>$54,059</td>
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<tr>
<td>18</td>
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<td>$1,689,966</td>
<td>$59,464</td>
<td>$2,517,303</td>
</tr>
<tr>
<td>19</td>
<td>$0</td>
<td>$1,808,264</td>
<td>$65,411</td>
<td>$2,739,629</td>
</tr>
<tr>
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<td>$71,952</td>
<td>$2,979,971</td>
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<tr>
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<td>$2,070,281</td>
<td>$79,147</td>
<td>$3,239,618</td>
</tr>
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<td>$3,519,935</td>
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<tr>
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<td>$95,768</td>
<td>$3,822,354</td>
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<tr>
<td>24</td>
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<td>$2,536,183</td>
<td>$103,345</td>
<td>$4,148,385</td>
</tr>
<tr>
<td>25</td>
<td>$0</td>
<td>$2,713,716</td>
<td>$115,879</td>
<td>$4,499,609</td>
</tr>
</tbody>
</table>

### Table 14.5: Comparison of Returns of Roth IRAs

<table>
<thead>
<tr>
<th>Year</th>
<th>5% Growth</th>
<th>10% Growth</th>
<th>15% Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Today</td>
<td>$250,000</td>
<td>$250,000</td>
<td>$250,000</td>
</tr>
<tr>
<td>5</td>
<td>$335,024</td>
<td>$442,890</td>
<td>$578,265</td>
</tr>
<tr>
<td>10</td>
<td>$427,585</td>
<td>$713,279</td>
<td>$1,163,098</td>
</tr>
<tr>
<td>15</td>
<td>$545,719</td>
<td>$1,148,743</td>
<td>$2,339,405</td>
</tr>
<tr>
<td>20</td>
<td>$696,491</td>
<td>$1,850,062</td>
<td>$4,705,380</td>
</tr>
<tr>
<td>25</td>
<td>$888,918</td>
<td>$2,979,544</td>
<td>$9,464,199</td>
</tr>
</tbody>
</table>

4. A direct payment generally provides the beneficiary with a general power of appointment. This will also result in 100 percent of the postmortem growth being included in the estate of the decedent.
The Roth Legacy Trust allows for multigenerational planning. The use of this trust will allow longer control of funds within the family, thus guaranteeing its availability to grandchildren.

A Technical Perspective

The 1997 Act, along with the newly proposed IRC Section 401(a)(9) regulations, allows a Roth IRA holder to name either a revocable or an irrevocable trust as the beneficiary of a Roth IRA. When the proper procedures are followed, distributions from the Roth IRA will be paid over the life expectancy of the oldest trust beneficiary. Qualified distributions from the Roth IRA will be paid over the life expectancy of the oldest trust beneficiary. If the distributions from the Roth IRA are not paid by the trustee to the beneficiary, the earnings on the distributions will be subject to income tax at trust tax rates. If the earnings are paid to the beneficiary, a distributable net income (DNI) deduction should be available to the trust to the extent of the trust's taxable income.

Designing the Roth Legacy Trust Plan

Single-Generation Trust

The single-generation trust will typically be termed the Roth Legacy Trust. In the Roth Legacy Trust, the grantor (for example, surviving spouse) is creating a trust for the benefit of a particular child (or in some instances several children). In concept, this trust is very similar to a standard testamentary trust for the benefit of a child. Under the IRC Section 401(a)(9) regulations, distributions will be made over the life expectancy of the oldest trust beneficiary. Key provisions of such a trust would be as follows.

- The trustee should generally be an independent trustee.
- The trust should have adequate provisions for distributions for the health, education, and future retirement of a beneficiary.
- The trust should generally contain specific instructions to the trustee to take the smallest distribution under the RMD rules, unless such distributions would be distributed to a beneficiary.

3 If separate shares are created in the trust, each subtrust containing a separate share will be entitled to distributions based upon the individual beneficiary's life expectancy.

4 Treas. Reg. Sec. 1.401(a)(9)-5 Q&A 7(a).
under the education, health, and retirement scenario discussed above.

- From an estate tax perspective, the planner will need to review whether the trust should contain a general power of appointment, vesting the trust in the beneficiary’s estate, or contain a limited power of appointment. It will be important that the general power of appointment be structured so as not to run afoul of the requirements of a trust being a qualified designated beneficiary. Since the trust will be long-term, this will be a critical tax and practical question. When evaluating this decision, the grantor must determine whether or not the beneficiary would follow a distribution plan that would be acceptable to the grantor, or whether the grantor should simply provide that at the death of the primary beneficiary the trust will pass to specified individuals. If this occurs, we would typically be working with a multiple-generation trust. The trustee should—

- Have the power to make in-kind distributions.
- Have the authority to continue the trust at the death of a child.
- Have the power to cash out nonindividual beneficiaries.
- Be very specific that distributions from the Roth IRA to the trustee will be based upon the life expectancy of the oldest trust beneficiary. Further, if that beneficiary dies, distributions should continue over the remaining nonrecalculated life expectancy.

Distributions over a child’s life expectancy to a Roth Legacy Trust are shown in table 14.6, “Client Leaves $500,000 IRA to Child.”

Multiple-Generation Trust

In the multiple-generation trust, the grantor is designing the trust for the benefit of several generations (typically, either or both children and grandchildren). This trust will be termed the Roth Dynasty Trust.

Distributions over a grandchild’s life expectancy are shown in table 14.7, “Client Leaves $500,000 to Grandchild.”

---

5 Assumes the child is age 40 and the growth rate on the IRA is 10 percent.
6 Assumes the grandchild is age 10 and the growth rate on the IRA is 10 percent.
Table 14.6: Client Leaves $500,000 IRA to Child

<table>
<thead>
<tr>
<th>Year</th>
<th>Pension Fund Beginning Value</th>
<th>Life Expectancy</th>
<th>Annual Distribution</th>
</tr>
</thead>
<tbody>
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<td>$11,765</td>
</tr>
<tr>
<td>2</td>
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<td>$12,941</td>
</tr>
<tr>
<td>3</td>
<td>$576,529</td>
<td>40.5</td>
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</tr>
<tr>
<td>4</td>
<td>$618,524</td>
<td>39.5</td>
<td>$15,659</td>
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<tr>
<td>5</td>
<td>$663,151</td>
<td>38.5</td>
<td>$17,225</td>
</tr>
<tr>
<td>6</td>
<td>$710,519</td>
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</tr>
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<td>$27,741</td>
</tr>
<tr>
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</tr>
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</tr>
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<tr>
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<tr>
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<td>$2,519,432</td>
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<td>$186,625</td>
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</tbody>
</table>

Generation-Skipping Transfer Tax Aspects

Whether you are designing a single-generation trust or a multiple-generation trust, special care must be taken to allocate generation-skipping transfer (GST) tax exemption when appropriate. Generally, if a trust is for a child and that child has a general power of appointment,\(^7\) it will not be necessary to allocate GST exemption. This occurs because the trust is vested in the estate of the child. However, in instances in which a trust is for the benefit of a particular child, and in the event that the child dies before reaching a particular age, the trust shall pass to his or her issue, and

---

\(^7\) Care must be taken in drafting a general power of appointment so as to ensure that the oldest trust beneficiary is an identifiable individual.
Table 14.7: Client Leaves $500,000 to Grandchild

<table>
<thead>
<tr>
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<td>$4,723,529</td>
<td>42.7</td>
<td>$110,621</td>
</tr>
</tbody>
</table>

It may be necessary to allocate GST exemption. Lastly, in those situations in which a trust is strictly for the benefit of a grandchild, it will be necessary to allocate GST exemption to this trust. Furthermore, in those instances in which a trust is for the benefit of a child and, subsequently, grandchildren (with no intervening general power of appointment), GST tax exemption should also be allocated.
Flow Charts of Roth Legacy Trusts

Figure 14.1, "Operation of Roth Legacy Trust—Lifetime Beneficiaries," depicts the operation of a Roth Legacy Trust where spouse and children are the beneficiaries during their lifetimes. RMDs are made to the trust based upon the spouse's life expectancy. The spouse has a limited power of appointment, exercisable at his or her death, to appoint which children are to be the ultimate beneficiaries upon termination of the trust.

**Figure 14.1: Operation of Roth Legacy Trust—Lifetime Beneficiaries**

- IRA
- Legacy Trust
  - Trustee May invade
  - Discretionary Income and Corpus to Spouse and Issue
  - In Kind Distributions upon Spouse's Death by Limited Power of Appointment
    - Child or Issue (assuming age 25)
    - Child or Issue (assuming age 25)
    - Child or Issue (assuming age 25)

Note: Minimum Distributions are made to the Trust over the Oldest Beneficiary's Life Expectancy (Spouse)
Figure 14.2, "Operation of a Roth Legacy Trust—Discretionary Distributions," depicts the use of a Roth Legacy Trust if the trustee has authority to make discretionary distributions to children and or issue of deceased children. RMDs are made to the trust over the oldest child’s life expectancy. Upon the death of the trustor and, further, when the youngest beneficiary has reached age 25, the trust assets are distributed.

**Figure 14.2: Operation of a Roth Legacy Trust—Discretionary Distributions**

Diagram showing the flow of funds from IRA to Legacy Trust and then to beneficiaries.

- IRA
- Legacy Trust
- Trustee May Invade
- Discretionary Income and Corpus to Children or Issue of Deceased Child
- Child or Issue of Deceased Child (assuming age 25)
- Child or Issue of Deceased Child (assuming age 25)
- Child or Issue of Deceased Child (assuming age 25)

**Note:** Minimum Distributions are made to the Trust over the Oldest Beneficiary’s Life Expectancy (Child)

In Kind Distributions at Trustor’s Death and upon youngest beneficiary reaching age 25
Figure 14.3, "Operation of Roth Legacy Trust—Discretionary Payments to Beneficiaries," illustrates the use of a Roth Legacy Trust where children and grandchildren are beneficiaries of discretionary payments. Required minimum distributions are made to the trust over the life expectancy of the oldest child. Upon the death of the last living child, the trust is disbursed to those grandchildren who have attained twenty-five years of age. If any grandchild has not yet attained this age, his or her share will be held in trust until such time as he or she reaches twenty-five.

**Figure 14.3: Operation of Roth Legacy Trust—Discretionary Payments to Beneficiaries**

- IRA
- Legacy Trust
- Discretionary Income and Corpus to Children and Grandchildren
- Trustee May Invade

Note: Minimum distributions are made to the trust over the oldest beneficiary's life expectancy (Child).

In Kind Distributions at Death of Last Living Child

- Grandchild (assuming age 25)
- Grandchild (assuming age 25)
- Grandchild (assuming age 25)
Finally, Figure 14.4, "Operation of a Roth Legacy Trust—Discretionary Payments to Grandchildren Only," outlines the use of a Roth Legacy Trust where only the grandchildren are beneficiaries of discretionary payments. Required minimum distributions are made to the trust over the life expectancy of the oldest grandchild. Upon the death of the Trustor and the youngest grandchild reaching age 65, the trust is terminated and the proceeds are disbursed to the grandchildren.

**Figure 14.4: Operation of Roth Legacy Trust—Discretionary Payments to Grandchildren Only**

IRA

---

Legacy Trust

\[\rightarrow\]

Discretionary Income and Corpus to Grandchild

\[\rightarrow\]

Grandchild

\[\rightarrow\]

Grandchild

\[\rightarrow\]

Grandchild

---

Note: Minimum Distributions are made to the Trust over the Oldest Beneficiary's Life Expectancy (Grandchild)

In Kind Distributions at Trustor's Death and upon youngest Grandchild reaching age 65
The Roth Legacy Trust continues to be an exciting planning technique that will be used by both wealthy and middle-class families. The Roth Legacy Trust and the Roth Dynasty Trust both provide substantial income tax, estate tax, and GST tax advantages. These advantages will be critical in designing estate plans in the years to come. Prior to any client making a decision not to convert at least a portion of his or her IRA to a Roth IRA, he or she may wish to become familiar with the advantages and disadvantages of the Roth Legacy Trust and Roth Dynasty Trust.
Appendix A: Taxpayer Relief Act of 1997

Title III—Savings and Investment Incentives

Subtitle A—Retirement Savings

Sec. 301. Restoration of IRA Deduction for Certain Taxpayers.

(a) Increase in Income Limits Applicable to Active Participants.

(1) In General.—Subparagraph (B) of section 219(g)(3) (relating to applicable dollar amount) is amended to read as follows:

"(B) Applicable Dollar Amount.—The term ‘applicable dollar amount’ means the following:

(i) In the case of a taxpayer filing a joint return:

<table>
<thead>
<tr>
<th>Year</th>
<th>Applicable Dollar Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
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<tr>
<td>2007 and thereafter</td>
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</tbody>
</table>

(ii) In the case of any other taxpayer (other than a married individual filing a separate return):

<table>
<thead>
<tr>
<th>Year</th>
<th>Applicable Dollar Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>$30,000</td>
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<tr>
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<td>2004</td>
<td>$45,000</td>
</tr>
<tr>
<td>2005 and thereafter</td>
<td>$50,000</td>
</tr>
</tbody>
</table>

(iii) In the case of a married individual filing a separate return, zero.

(2) Increase in Phase-out Range for Joint Returns.—Clause (ii) of section 219(g)(2)(A) is amended by inserting "($20,000 in the case of a joint return for a taxable year beginning after December 31, 2006)."

(b) Limitations for Active Participation Not Based on Spouse’s Participation.—Section 219(g) (relating to limitation on deduction for active participants in certain pension plans) is amended—

(1) by striking "or the individual’s spouse" in paragraph (1), and

(2) by adding at the end the following new paragraph:
"(7) SPECIAL RULE FOR CERTAIN SPOUSES.—In the case of an individual who is an active participant at no time during any plan year ending with or within the taxable year but whose spouse is an active participant for any part of any such plan year—

"(A) the applicable dollar amount under paragraph (3)(B)(i) with respect to the taxpayer shall be $150,000, and

"(B) the amount applicable under paragraph (2)(A)(ii) shall be $10,000."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1997.

SEC. 302. ESTABLISHMENT OF NONDEDUCTIBLE TAX-FREE INDIVIDUAL RETIREMENT ACCOUNTS.

(a) IN GENERAL.—Subpart A of part I of subchapter D of chapter 1 (relating to pension, profit-sharing, stock bonus plans, etc.) is amended by inserting after section 408 the following new section:

"SEC. 408A. ROTH IRAS.

"(a) GENERAL RULE.—Except as provided in this section, a Roth IRA shall be treated for purposes of this title in the same manner as an individual retirement plan.

"(b) ROTH IRA.—For purposes of this title, the term 'Roth IRA' means an individual retirement plan (as defined in section 7701(a)(37)) which is designated (in such manner as the Secretary may prescribe) at the time of establishment of the plan as a Roth IRA. Such designation shall be made in such manner as the Secretary may prescribe.

"(c) TREATMENT OF CONTRIBUTIONS.—

"(1) NO DEDUCTION ALLOWED.—No deduction shall be allowed under section 219 for a contribution to a Roth IRA.

"(2) CONTRIBUTION LIMIT.—The aggregate amount of contributions for any taxable year to all Roth IRAs maintained for the benefit of an individual shall not exceed the excess (if any) of—

"(A) the maximum amount allowable as a deduction under section 219 with respect to such individual for such taxable year (computed without regard to subsection (d)(1) or (g) of such section), over

"(B) the aggregate amount of contributions for such taxable year to all other individual retirement plans (other than Roth IRAs) maintained for the benefit of the individual.

"(3) LIMITS BASED ON MODIFIED ADJUSTED GROSS INCOME.—

"(A) DOLLAR LIMIT.—The amount determined under paragraph (2) for any taxable year shall be reduced (but not below zero) by the amount which bears the same ratio to such amount as—

"(i) the excess of—

"(I) the taxpayer's adjusted gross income for such taxable year, over

"(II) the applicable dollar amount, bears to

"(ii) $15,000 ($10,000 in the case of a joint return). The rules of subparagraphs (B) and (C) of section 219(g)(2) shall apply to any reduction under this subparagraph.

"(B) ROLLOVER FROM IRA.—A taxpayer shall not be allowed to make a qualified rollover contribution to a Roth IRA from an individual retirement plan other than a Roth IRA during any taxable year if—
"(i) the taxpayer’s adjusted gross income for such taxable year exceeds $100,000, or
"(ii) the taxpayer is a married individual filing a separate return.
"(C) DEFINITIONS.—For purposes of this paragraph—
“(i) adjusted gross income shall be determined in the same manner as under section 219(g)(3), except that any amount included in gross income under subsection (d)(3) shall not be taken into account and the deduction under section 219 shall be taken into account, and
“(ii) the applicable dollar amount is—
“(I) in the case of a taxpayer filing a joint return, $150,000,
“(II) in the case of any other taxpayer (other than a married individual filing a separate return), $95,000, and
“(III) in the case of a married individual filing a separate return, zero.
“(D) MARITAL STATUS.—Section 219(g)(4) shall apply for purposes of this paragraph.
“(4) CONTRIBUTIONS PERMITTED AFTER AGE 70½.—Contributions to a Roth IRA may be made even after the individual for whom the account is maintained has attained age 70½.
“(5) MANDATORY DISTRIBUTION RULES NOT TO APPLY BEFORE DEATH.—Notwithstanding subsections (a)(6) and (b)(3) of section 408 (relating to required distributions), the following provisions shall not apply to any Roth IRA:
“(A) Section 401(a)(9)(A).
“(B) The incidental death benefit requirements of section 401(a).
“(6) ROLLOVER CONTRIBUTIONS.—
“(A) IN GENERAL.—No rollover contribution may be made to a Roth IRA unless it is a qualified rollover contribution.
“(B) COORDINATION WITH LIMIT.—A qualified rollover contribution shall not be taken into account for purposes of paragraph (2).
“(7) TIME WHEN CONTRIBUTIONS MADE.—For purposes of this section, the rule of section 219(f)(3) shall apply.
“(d) DISTRIBUTION RULES.—For purposes of this title—
“(1) GENERAL RULES.—
“(A) EXCLUSIONS FROM GROSS INCOME.—Any qualified distribution from a Roth IRA shall not be includible in gross income.
“(B) NONQUALIFIED DISTRIBUTIONS.—In applying section 72 to any distribution from a Roth IRA which is not a qualified distribution, such distribution shall be treated as made from contributions to the Roth IRA to the extent that such distribution, when added to all previous distributions from the Roth IRA, does not exceed the aggregate amount of contributions to the Roth IRA.
“(2) QUALIFIED DISTRIBUTION.—For purposes of this subsection—
“(A) IN GENERAL.—The term ‘qualified distribution’ means any payment or distribution—
“(i) made on or after the date on which the individual attains age 59½,
“(ii) made to a beneficiary (or to the estate of the individual) on or after the death of the individual,
“(iii) attributable to the individual's being disabled (within the meaning of section 72(m)(7)), or
“(iv) which is a qualified special purpose distribution.
“(B) CERTAIN DISTRIBUTIONS WITHIN 5 YEARS.—A payment or distribution shall not be treated as a qualified distribution under subparagraph (A) if—
“(i) it is made within the 5-taxable year period beginning with the 1st taxable year for which the individual made a contribution to a Roth IRA (or such individual's spouse made a contribution to a Roth IRA) established for such individual, or
“(ii) in the case of a payment or distribution properly allocable (as determined in the manner prescribed by the Secretary) to a qualified rollover contribution from an individual retirement plan other than a Roth IRA (or income allocable thereto), it is made within the 5-taxable year period beginning with the taxable year in which the rollover contribution was made.
“(3) ROLLOVERS FROM AN IRA OTHER THAN A ROTH IRA.—
“(A) IN GENERAL.—Notwithstanding section 408(d)(3), in the case of any distribution to which this paragraph applies—
“(i) there shall be included in gross income any amount which would be includible were it not part of a qualified rollover contribution,
“(ii) section 72(t) shall not apply, and
“(iii) in the case of a distribution before January 1, 1999, any amount required to be included in gross income by reason of this paragraph shall be so included ratably over the 4-taxable year period beginning with the taxable year in which the payment or distribution is made.
“(B) DISTRIBUTIONS TO WHICH PARAGRAPH APPLIES.—This paragraph shall apply to a distribution from an individual retirement plan (other than a Roth IRA) maintained for the benefit of an individual which is contributed to a Roth IRA maintained for the benefit of such individual in a qualified rollover contribution.
“(C) CONVERSIONS.—The conversion of an individual retirement plan (other than a Roth IRA) to a Roth IRA shall be treated for purposes of this paragraph as a distribution to which this paragraph applies.
“(D) CONVERSION OF EXCESS CONTRIBUTIONS.—If, no later than the due date for filing the return of tax for any taxable year (without regard to extensions), an individual transfers, from an individual retirement plan (other than a Roth IRA), contributions for such taxable year (and any earnings allocable thereto) to a Roth IRA, no such amount shall be includible in gross income to the extent no deduction was allowed with respect to such amount.
“(E) ADDITIONAL REPORTING REQUIREMENTS.—Trustees of Roth IRAs, trustees of individual retirement plans, or both, whichever is appropriate, shall include such additional information in reports required under section 408(i) as the Secretary may require to ensure that amounts re-
required to be included in gross income under subparagraph (A) are so included.

“(4) COORDINATION WITH INDIVIDUAL RETIREMENT ACCOUNTS.—Section 408(d)(2) shall be applied separately with respect to Roth IRAs and other individual retirement plans.

“(5) QUALIFIED SPECIAL PURPOSE DISTRIBUTION.—For purposes of this section, the term ‘qualified special purpose distribution’ means any distribution to which subparagraph (F) of section 72(t)(2) applies.

“(e) QUALIFIED ROLLOVER CONTRIBUTION.—For purposes of this section, the term ‘qualified rollover contribution’ means a rollover contribution to a Roth IRA from another such account, or from an individual retirement plan, but only if such rollover contribution meets the requirements of section 408(d)(3). For purposes of section 408(d)(3)(B), there shall be disregarded any qualified rollover contribution from an individual retirement plan (other than a Roth IRA) to a Roth IRA.”

(b) EXCESS CONTRIBUTIONS.—Section 4973(b), as amended by title II, is amended by adding at the end the following new subsection:

“(f) EXCESS CONTRIBUTIONS TO ROTH IRAs.—For purposes of this section, in the case of contributions to a Roth IRA (within the meaning of section 408A(b)), the term ‘excess contributions’ means the sum of—

“(1) the excess (if any) of—

“(A) the amount contributed for the taxable year to such accounts (other than a qualified rollover contribution described in section 408A(e)), over

“(B) the amount allowable as a contribution under sections 408A (c)(2) and (c)(3), and

“(2) the amount determined under this subsection for the preceding taxable year, reduced by the sum of—

“(A) the distributions out of the accounts for the taxable year, and

“(B) the excess (if any) of the maximum amount allowable as a contribution under sections 408A (c)(2) and (c)(3) for the taxable year over the amount contributed to the accounts for the taxable year.

For purposes of this subsection, any contribution which is distributed from a Roth IRA in a distribution described in section 408(d)(4) shall be treated as an amount not contributed.”

(c) SPOUSAL IRA.—Clause (ii) of section 219(c)(1)(B) is amended to read as follows:

“(ii) the compensation includible in the gross income of such individual’s spouse for the taxable year reduced by—

“(I) the amount allowed as a deduction under subsection (a) to such spouse for such taxable year, and

“(II) the amount of any contribution on behalf of such spouse to a Roth IRA under section 408A for such taxable year.”.

(d) AUTHORITY TO PRESCRIBE NECESSARY REPORTING.—Section 408(i) is amended—

(1) by striking “under regulations”, and

(2) by striking “in such regulations” each place it appears.
(e) CONFORMING AMENDMENT.—The table of sections for subpart A of part I of subchapter D of chapter 1 is amended by inserting after the item relating to section 408 the following new item:

"Sec. 408A. Roth IRAs."

(f) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1997.

SEC. 303. DISTRIBUTIONS FROM CERTAIN PLANS MAY BE USED WITHOUT PENALTY TO PURCHASE FIRST HOMES.

(a) IN GENERAL.—Paragraph (2) of section 72(t) (relating to exceptions to 10-percent additional tax on early distributions from qualified retirement plans), as amended by section 203, is amended by adding at the end the following new subparagraph:

"(F) DISTRIBUTIONS FROM CERTAIN PLANS FOR FIRST HOME PURCHASES.—Distributions to an individual from an individual retirement plan which are qualified first-time homebuyer distributions (as defined in paragraph (8)). Distributions shall not be taken into account under the preceding sentence if such distributions are described in subparagraph (A), (C), (D), or (E) or to the extent paragraph (1) does not apply to such distributions by reason of subparagraph (B)."

(b) DEFINITIONS.—Section 72(t), as amended by section 203, is amended by adding at the end the following new paragraphs:

"(8) QUALIFIED FIRST-TIME HOMEBUYER DISTRIBUTIONS.—For purposes of paragraph (2)(F)—

"(A) IN GENERAL.—The term 'qualified first-time homebuyer distribution' means any payment or distribution received by an individual to the extent such payment or distribution is used by the individual before the close of the 120th day after the day on which such payment or distribution is received to pay qualified acquisition costs with respect to a principal residence of a first-time homebuyer who is such individual, the spouse of such individual, or any child, grandchild, or ancestor of such individual or the individual's spouse.

"(B) LIFETIME DOLLAR LIMITATION.—The aggregate amount of payments or distributions received by an individual which may be treated as qualified first-time homebuyer distributions for any taxable year shall not exceed the excess (if any) of—

"(i) $10,000, over

"(ii) the aggregate amounts treated as qualified first-time homebuyer distributions with respect to such individual for all prior taxable years.

"(C) QUALIFIED ACQUISITION COSTS.—For purposes of this paragraph, the term 'qualified acquisition costs' means the costs of acquiring, constructing, or reconstructing a residence. Such term includes any usual or reasonable settlement, financing, or other closing costs.

"(D) FIRST-TIME HOMEBUYER; OTHER DEFINITIONS.—For purposes of this paragraph—

"(i) FIRST-TIME HOMEBUYER.—The term ‘first-time homebuyer’ means any individual if—

"(l) such individual (and if married, such individual’s spouse) had no present ownership interest in a principal residence during the 2-year period ending on the date of acquisition of the prin-
Appendix A: Taxpayer Relief Act of 1997

Principal residence to which this paragraph applies, and

"(II) subsection (h) or (k) of section 1034 (as in effect on the day before the date of the enactment of this paragraph) did not suspend the running of any period of time specified in section 1034 (as so in effect) with respect to such individual on the day before the date the distribution is applied pursuant to subparagraph (A).

"(ii) PRINCIPAL RESIDENCE.—The term 'principal residence' has the same meaning as when used in section 121.

"(iii) DATE OF ACQUISITION.—The term 'date of acquisition' means the date—

"(I) on which a binding contract to acquire the principal residence to which subparagraph (A) applies is entered into, or

"(II) on which construction or reconstruction of such a principal residence is commenced.

"(E) SPECIAL RULE WHERE DELAY IN ACQUISITION.—If any distribution from any individual retirement plan fails to meet the requirements of subparagraph (A) solely by reason of a delay or cancellation of the purchase or construction of the residence, the amount of the distribution may be contributed to an individual retirement plan as provided in section 408(d)(3)(A)(i) (determined by substituting '120 days' for '60 days' in such section), except that—

"(i) section 408(d)(3)(B) shall not be applied to such contribution, and

"(ii) such amount shall not be taken into account in determining whether section 408(d)(3)(B) applies to any other amount.”.

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to payments and distributions in taxable years beginning after December 31, 1997.
APPENDIX B:
CONFERENCE COMMITTEE EXPLANATION (1997 ACT)

2. Tax-free nondeductible IRAs (sec. 301 of the House bill and sec. 302 of the Senate amendment)

Present Law

No provision. However, present law provides that an individual can make nondeductible contributions to an IRA to the extent the individual cannot or does not make deductible contributions. Earnings on nondeductible contributions are includible in income when withdrawn.

House Bill

In general

The House bill replaces present-law nondeductible IRAs with new American Dream IRAs ("AD IRAs") to which individuals may make nondeductible contributions of up to $2,000 annually. No income limits apply to AD IRAs, and contributions to AD IRAs are in addition to other IRA contributions. The $2,000 contribution limit is indexed for inflation in $50 increments.

Taxation of distributions

Qualified distributions from an AD IRA are not includible in income. Qualified distributions are distributions (1) made after the 5-taxable year period beginning with the first taxable year for which a contribution was made to an AD IRA and (2) which are (a) made on or after the date on which the individual attains age 59½, (b) made to a beneficiary on or after the death of the individual, (c) attributable to the individual's being disabled, or (d) for a qualified special purpose distribution. A qualified special purpose distribution is a distribution for first-time homebuyer expenses.

Conversions of IRAs to AD IRAs

An IRA may be converted to an AD IRA before January 1, 1999. Amounts that would have been includible in income had the amounts converted been withdrawn are includible in income ratably over 4 years. The additional tax on early withdrawals does not apply to conversions of IRAs to AD IRAs.

Effective date

Taxable years beginning after December 31, 1997.

Senate Amendment

In general

Same as the House bill, except that: (1) the new IRAs are called IRA Plus accounts and (2) no more than $2,000 of annual contributions can be made to all an individual's IRAs.

Taxation of distributions

Same as the House bill, except that special purpose distributions also include distributions to long-term unemployed individuals.
Conversions of IRAs to AD IRAs

Same as the House bill, except that conversions of an IRA to an IRA Plus can be made at any time. If the conversion is made before January 1, 1999, the amounts that would have been includible in income had the amounts converted been withdrawn are includible in income ratably over 4 years. In any case, the 10-percent tax on early withdrawals does not apply.

Effective date

Same as the House bill.

Conference Agreement

The conference agreement follows the Senate amendment, with modifications. Under the conference agreement, the new IRA is called the “Roth IRA” rather than the IRA Plus. The maximum contribution that can be made to a Roth IRA is phased out for individuals with AGI between $95,000 and $110,000 and for joint filers with AGI between $150,000 and $160,000. Under the conference agreement, distributions to long-term unemployed individuals do not qualify as special purpose distributions. Thus, only first-time homebuyer expenses (as defined under the Senate amendment) qualify as special purpose distributions.

Under the conference agreement, only taxpayers with AGI of less than $100,000\(^{51}\) are eligible to roll over or convert an IRA into a Roth IRA.

The conference agreement retains present-law nondeductible IRAs. Thus, an individual who cannot (or does not) make contributions to a deductible IRA or a Roth IRA can make contributions to a nondeductible IRA. In no case can contributions to all an individual’s IRAs for a taxable year exceed $2,000.

3. Modifications to early withdrawal tax (sec. 301 of the House bill and sec. 303 of the Senate amendment)

Present Law

Under present law, a 10-percent additional tax applies to distributions from an IRA prior to age 59\(\frac{1}{2}\), unless an exception applies.

House Bill

The House bill adds an additional exception to the early withdrawal tax for AD IRAs only. The early withdrawal tax does not apply to distributions from an AD IRA for first-time homebuyer expenses, subject to a $10,000 life-time cap.

Effective date.—Taxable years beginning after December 31, 1997.

Senate Amendment

The early withdrawal tax does not apply to distributions from any IRA for first-time homebuyer expenses or for long-term unemployed individuals.

Effective date.—Same as the House bill.

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\(^{51}\) For this purpose, AGI is determined before any amount includible in income as a result of the rollover or conversion.
Conference Agreement

The conference agreement follows the Senate amendment but does not include the provision relating to long-term unemployed individuals.\(^{52}\)

\(^{52}\)As under the House bill and Senate amendment, the conference agreement includes a penalty-free withdrawal provision for education expenses.
APPENDIX C:
1998 ROTH IRA AMENDMENTS: TEXT

H.R.2676
Internal Revenue Service Restructuring and Reform Act of 1997 (Reported in the Senate)

SEC. 6005. AMENDMENTS RELATED TO TITLE III OF 1997 ACT.

(a) AMENDMENTS RELATED TO SECTION 301 OF 1997 ACT-

(1) Section 219(g) of the 1986 Code is amended--

(A) by inserting 'or the individual's spouse' after 'individual' in paragraph (1), and

(B) by striking paragraph (7) and inserting:

'(7) SPECIAL RULE FOR SPOUSES WHO ARE NOT ACTIVE PARTICIPANTS- If this subsection applies to an individual for any taxable year solely because their spouse is an active participant, then, in applying this subsection to the individual (but not their spouse)---

'(A) the applicable dollar amount under paragraph (3)(B)(i) shall be $150,000, and

'(B) the amount applicable under paragraph (2)(A)(ii) shall be $10,000.'

(2) Paragraph (2) of section 301(a) of the 1997 Act is amended by inserting 'after "$10,000' before the period.

(b) AMENDMENTS RELATED TO SECTION 302 OF 1997 ACT-

(1) Section 408A(c)(3)(A) of the 1986 Code is amended by striking 'shall be reduced' and inserting 'shall not exceed an amount equal to the amount determined under paragraph (2)(A) for such taxable year, reduced'.

(2) Section 408A(c)(3) of the 1986 Code (relating to limits based on modified adjusted gross income) is amended--

(A) by inserting 'or a married individual filing a separate return' after 'joint return' in subparagraph (A)(ii),
(B) in subparagraph (B)–

(i) by inserting ', for the taxable year of the distribution to which such contribution relates' after 'if', and

(ii) by striking 'for such taxable year' in clause (i), and

(C) by striking 'and the deduction under section 219 shall be taken into account' in subparagraph (C)(i).

(3)(A) Section 408A(d)(2) of the 1986 Code (defining qualified distribution) is amended by striking subparagraph (B) and inserting the following:

'(B) DISTRIBUTIONS WITHIN NONEXCLUSION PERIOD- A payment or distribution from a Roth IRA shall not be treated as a qualified distribution under subparagraph (A) if such payment or distribution is made within the 5-taxable year period beginning with the 1st taxable year for which the individual made a contribution to a Roth IRA (or such individual’s spouse made a contribution to a Roth IRA) established for such individual.'

(B) Section 408A(d)(2) of the 1986 Code is amended by adding at the end the following new subparagraph:

'(C) DISTRIBUTIONS OF EXCESS CONTRIBUTIONS AND EARNINGS- The term 'qualified distribution' shall not include any distribution of any contribution described in section 408A(d)(4) and any net income allocable to the contribution.'
APPENDIX D: 1998 ROTH IRA AMENDMENTS: COMMITTEE REPORT

Calendar No. 341

105TH CONGRESS 2d Session SENATE REPORT 105-174

INTERNAL REVENUE SERVICE RESTRUCTURING AND REFORM ACT OF 1998

APRIL 22, 1998.—Ordered to be printed

Mr. ROTH, from the Committee on Finance, submitted the following

REPORT

[To accompany H.R. 2676]

The Committee on Finance, to which was referred the bill (H.R. 2676) to amend the Internal Revenue Code of 1986 to restructure and reform the Internal Revenue Service, and for other purposes, having considered the same, reports favorably thereon with an amendment and recommends that the bill as amended do pass.

C. AMENDMENTS TO TITLE III OF THE 1997 ACT RELATING TO SAVINGS INCENTIVES

1. Conversions of IRAs into Roth IRAs (sec. 6005(b) of the bill, sec. 302 of the 1997 Act, and secs. 408A and 72(t) of the Code)

Present Law

A taxpayer with adjusted gross income of less than $100,000 may convert a present-law deductible or nondeductible IRA into a Roth IRA at any time. The amount converted is includible in income in the year of the conversion, except that if the conversion occurs in 1998, the amount converted is includible in income ratably over the 4-year period beginning with the year in which the conversion occurs. Amounts includible in income as a result of the conversion are not taken into account in determining whether the $100,000 threshold is exceeded. The 10-percent tax on early withdrawals does not apply to conversions of IRAs into Roth IRAs.

62 If the conversion is accomplished by means of a withdrawal and a rollover into a Roth IRA, the 4-year rule applies if the withdrawal is made during 1998 and the rollover occurs within 60 days of the withdrawal. In such a case, the 4-year period begins with the year in which the withdrawal was made. For purposes of this discussion, such conversions are treated as occurring in 1998.
In general, distributions of earnings from a Roth IRA are excludable from income if the individual has had a Roth IRA for at least 5 years and certain other requirements are satisfied. The 5-year holding period with respect to conversion Roth IRAs begins from the year of the conversion. (Distributions that are excludable from income are referred to as qualified distributions.) Present law does not contain a specific rule addressing what happens if an individual dies during the 4-year spread period for 1998 conversions.

Explanation of Provision

Distributions of converted amounts

Distributions before the end of the 4-year spread

The bill modifies the rules relating to conversions of IRAs into Roth IRAs in order to prevent taxpayers from receiving premature distributions from a Roth conversion IRA while retaining the benefits of 4-year income averaging. In the case of conversions to which the 4-year income inclusion rule applies, income inclusion will be accelerated with respect to any amounts withdrawn before the final year of inclusion. Under this rule, a taxpayer that withdraws converted amounts prior to the last year of the 4-year spread will be required to include in income the amount otherwise includable under the 4-year rule, plus the lesser of (1) the taxable amount of the withdrawal, or (2) the remaining taxable amount of the conversion (i.e., the taxable amount of the conversion not included in income under the 4-year rule in the current or a prior taxable year). In subsequent years (assuming no such further withdrawals), the amount includable in income under the 4-year rule will 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.

Under the bill, application of the 4-year spread will be elective. The election will be made in the time and manner prescribed by the Secretary. If no election is made, the 4-year rule will be deemed to be elected. An election, or deemed election, with respect to the 4-year spread cannot be changed after the due date for the return for the first year of the income inclusion (including extensions). The following example illustrates the application of these rules.

Example: Taxpayer A has a nondeductible IRA with a value of $100 (and no other IRAs). The $100 consists of $75 of contributions and $25 of earnings. A converts the IRA into a Roth IRA in 1998 and elects the 4-year spread. As a result of the conversion, $25 is includable in income ratably over 4 years ($6.25 per year). The 10-percent early withdrawal tax does not apply to the conversion. At the beginning of 1999, the value of the account is $110, and A makes a withdrawal of $10. Under the proposal, the withdrawal would be treated as attributable entirely to amounts that were includable in income due to the conversion. In the year of withdrawal, $16.25 would be includable in income (the $6.25 includible in the year of withdrawal under the 4-year rule, plus $10 ($10 is less than the remaining taxable amount of $12.50 ($25–$12.50)). In the next year, $2.50 would be includable in income under the 4-year rule. No amount would be includable in income in year 4 due to the conversion.
Application of early withdrawal tax to converted amounts

The bill modifies the rules relating to conversions to prevent taxpayers from receiving premature distributions (i.e., within 5 years) while retaining the benefit of the nonpayment of the early withdrawal tax. Under the bill, if converted amounts are withdrawn within the 5-year period beginning with the year of the conversion, then, to the extent attributable to amounts that were includible in income due to the conversion, the amount withdrawn will be subject to the 10-percent early withdrawal tax.63

Applying this rule to the example above, the $10 withdrawal would be subject to the 10-percent early withdrawal tax (unless as exception applies).

Application of 5-year holding period

The bill will also eliminate the special rule under which a separate 5-year holding period begins for purposes of determining whether a distribution of amounts attributable to a conversion is a qualified distribution; thus, the 5-year holding rule for Roth IRAs will begin with the year for which a contribution is first made to a Roth IRA. A subsequent conversion will not start the running of a new 5-year period.

Ordering rules

Ordering rules will apply to determine what amounts are withdrawn in the event a Roth IRA contains both conversion amounts (possibly from different years) and other contributions. Under these rules, regular Roth IRA contributions will be deemed to be withdrawn first, then converted amounts (starting with the amounts first converted). Withdrawals of converted amounts will be treated as coming first from converted amounts that were includible in income. As under present law, earnings will be treated as withdrawn after contributions. For purposes of these rules, all Roth IRAs, whether or not maintained in separate accounts, will be considered a single Roth IRA.

Corrections

In order to assist individuals who erroneously convert IRAs into Roth IRAs or otherwise wish to change the nature of an IRA contribution, contributions to an IRA (and earnings thereon) may be transferred in a trustee-to-trustee transfer from any IRA to another IRA by the due date for the taxpayer's return for the year of the contribution (including extensions). Any such transferred contributions will be treated as if contributed to the transferee IRA (and not to the transferor IRA). Trustee-to-trustee transfers include transfers between IRA trustees as well as IRA custodians, apply to transfers from and to IRA accounts and annuities, and apply to transfers between IRA accounts and annuities with the same trustee or custodian.

63 The otherwise available exceptions to the early withdrawal tax, e.g., for distributions after age 59½, would apply.
Effect of death on 4-year spread

Under the bill, in general, any amounts remaining to be included in income as a result of a 1998 conversion will be includible in income on the final return of the taxpayer. If the surviving spouse is the sole beneficiary of the Roth IRA, the spouse may continue the deferral by including the remaining amounts in his or her income over the remainder of the 4-year period.

Calculation of AGI limit for conversions

The bill clarifies the determination of AGI for purposes of applying the $100,000 AGI limit on IRA conversions into Roth IRAs. Under the bill, the conversion amount (to the extent otherwise includible in AGI) is subtracted from AGI as determined under the rules relating to IRAs (sec. 219) for the year of distribution. Thus, for example, the AGI-based phase out of the exemption from the disallowance for passive activity losses from rental real estate activities (sec. 469(i)(3)) would be applied taking into account the amount of the conversion that is includible in AGI, and then the amount of the conversion would be subtracted from AGI in determining whether a taxpayer is eligible to convert an IRA into a Roth IRA.

Effective Date

The provision is effective as if included in the 1997 Act, i.e., for taxable years beginning after December 31, 1997.

2. Penalty-free distributions for education expenses and purchase of first homes (sec. 6005(c) of the bill, secs. 203 and 303 of the 1997 Act, and sec. 402 of the Code)

Present Law

The 10-percent early withdrawal tax does not apply to distributions from an IRA if the distribution is for first-time homebuyer expenses, subject to a $10,000 life-time cap, or for higher education expenses. These exceptions do not apply to distributions from employer-sponsored retirement plans. A distribution from an employer-sponsored retirement plan that is an "eligible rollover distribution" may be rolled over to an IRA. The term "eligible rollover distribution" means any distribution to an employee of all or a portion or the balance to the credit of the employee in a qualified trust, except the term does not include certain periodic distributions, distributions based on life or joint life expectancies and distributions required under the minimum distribution rules. Generally, distributions from cash or deferred arrangements made on account of hardship are eligible rollover distributions. An eligible rollover distribution which is not transferred directly to another retirement plan or an IRA is subject to 20-percent withholding on the distribution.

Explanation of Provision

Under present law, participants in employer-sponsored retirement plans can avoid the early withdrawal tax applicable to such plans by rolling over hardship distributions to an IRA and with-
drawing the funds from the IRA. The bill modifies the rules relating to the ability to roll over hardship distributions from employer-sponsored retirement plans (including section 403(b) plans) in order to prevent such avoidance of the 10-percent early withdrawal tax. The bill provides that distributions from cash or deferred arrangements and similar arrangements made on account of hardship of the employee are not eligible rollover distributions. Such distributions will not be subject to the 20-percent withholding applicable to eligible rollover distributions.

Effective Date

The provision is effective for distributions after December 31, 1998.

3. Limits based on modified adjusted gross income (sec. 6005(b) of the bill, sec. 302(a) of the 1997 Act, and sec. 72(t) of the Code)

Present Law

The $2,000 Roth IRA maximum contribution limit is phased out for individual taxpayers with adjusted gross income ("AGI") between $95,000 and $110,000 and for married taxpayers filing a joint return with AGI between $150,000 and $160,000. The maximum deductible IRA contribution is phased out between $0 and $10,000 of AGI in the case of married couples filing a separate return.

Explanation of Provision

The bill clarifies the phase-out range for the Roth IRA maximum contribution limit for a married individual filing a separate return and conforms it to the range for deductible IRA contributions. Under the bill, the phase-out range for married individuals filing a separate return will be $0 to $10,000 of AGI.

Effective Date

The provision is effective as if included in the 1997 Act, i.e., for taxable years beginning after December 31, 1997.

4. Contribution limit to Roth IRAs (sec. 6005(b) of the bill, sec. 302 of the 1997 Act, and sec. 408A(c) of the Code)

Present Law

An individual who is an active participant in an employer-sponsored plan may deduct annual IRA contributions up to the lesser of $2,000 or 100 percent of compensation if the individual's adjusted gross income ("AGI") does not exceed certain limits. For 1998, the limit is phased-out over the following ranges of AGI: $30,000 to $40,000 in the case of a single taxpayer and $50,000 to $60,000 in the case of married taxpayers. An individual who is not an active participant in an employer-sponsored retirement plan (and whose spouse is not an active participant) may deduct IRA contributions up to the limits described above without limitation based on income. An individual who is not an active participant in an employer-sponsored retirement plan (and whose spouse is such
an active participant) may deduct IRA contributions up to the limits described above if the AGI of the such individuals filing a joint return does not exceed certain limits. The limit is phased out for such individuals with AGI between $150,000 and $160,000.

An individual may make nondeductible contributions up to the lesser of $2,000 or 100 percent of compensation to a Roth IRA if the individual's AGI does not exceed certain limits. An individual may make nondeductible contributions to an IRA to the extent the individual does not or cannot make deductible contributions to an IRA or contributions to a Roth IRA. Contributions to all an individual's IRAs for a taxable year may not exceed $2,000.

**Explanation of Provision**

The bill clarifies the intent of the Act that an individual may contribute up to $2,000 a year to all the individual's IRAs. Thus, for example, suppose an individual is not eligible to make deductible IRA contributions because of the phase-out limits, and is eligible to make a $1,000 Roth IRA contribution. The individual could contribute $1,000 to the Roth IRA and $1,000 to a nondeductible IRA.

**Effective Date**

The provision is effective as if included in the 1997 Act, i.e., for taxable years beginning after December 31, 1997.

5. Contribution limitations for active participants in an IRA (sec. 6005(a) of the bill, sec. 301(b) of the 1997 Act, and sec. 219(g) of the Code)

**Present Law**

Under present law, if a married individual (filing a joint return) is an active participant in an employer-sponsored retirement plan, the $2,000 IRA deduction limit is phased out over the following levels of adjusted gross income ("AGI"):

<table>
<thead>
<tr>
<th>Taxable years beginning in:</th>
<th>Phase-out range</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td>$40,000–50,000</td>
</tr>
<tr>
<td>1998</td>
<td>50,000–60,000</td>
</tr>
<tr>
<td>1999</td>
<td>51,000–61,000</td>
</tr>
<tr>
<td>2000</td>
<td>52,000–62,000</td>
</tr>
<tr>
<td>2001</td>
<td>53,000–63,000</td>
</tr>
<tr>
<td>2002</td>
<td>54,000–64,000</td>
</tr>
<tr>
<td>2003</td>
<td>60,000–70,000</td>
</tr>
<tr>
<td>2004</td>
<td>65,000–75,000</td>
</tr>
<tr>
<td>2005</td>
<td>70,000–80,000</td>
</tr>
<tr>
<td>2006</td>
<td>75,000–85,000</td>
</tr>
<tr>
<td>2007</td>
<td>80,000–100,000</td>
</tr>
</tbody>
</table>

An individual is not considered an active participant in an employer-sponsored retirement plan merely because the individual's spouse is an active participant. The $2,000 maximum deductible IRA contribution for an individual who is not an active participant, but whose spouse is, is phased out for taxpayers with AGI between $150,000 and $160,000.
Explanation of Provision

The bill clarifies the intent of the Act relating to the AGI phase-out ranges for married individuals who are active participants in employer-sponsored plans and the AGI phase-out range for spouses of such active participants as described above.

Effective Date

The provision is effective as if included in the 1997 Act, i.e., for taxable years beginning after December 31, 1997.
APPENDIX E: ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001: TEXT

TITLE VI—PENSION AND INDIVIDUAL RETIREMENT ARRANGEMENT PROVISIONS

Subtitle A—Individual Retirement Accounts

SEC. 601. MODIFICATION OF IRA CONTRIBUTION LIMITS.

(a) INCREASE IN CONTRIBUTION LIMIT.—

(1) IN GENERAL.—Paragraph (1)(A) of section 219(b) (relating to maximum amount of deduction) is amended by striking "$2,000" and inserting "the deductible amount".

(2) DEDUCTIBLE AMOUNT.—Section 219(b) is amended by adding at the end the following new paragraph:

"(5) DEDUCTIBLE AMOUNT.—For purposes of paragraph (1)(A)—

(A) IN GENERAL.—The deductible amount shall be determined in accordance with the following table:

<table>
<thead>
<tr>
<th>For taxable years beginning in:</th>
<th>The deductible amount is:</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002 through 2004</td>
<td>$3,000</td>
</tr>
<tr>
<td>2005 through 2007</td>
<td>$4,000</td>
</tr>
<tr>
<td>2008 and thereafter</td>
<td>$5,000</td>
</tr>
</tbody>
</table>

(B) CATCH-UP CONTRIBUTIONS FOR INDIVIDUALS 50 OR OLDER.—

(i) IN GENERAL.—In the case of an individual who has attained the age of 50 before the close of the taxable year, the deductible amount for such taxable year shall be increased by the applicable amount.

(ii) APPLICABLE AMOUNT.—For purposes of clause (i), the applicable amount shall be the amount determined in accordance with the following table:

<table>
<thead>
<tr>
<th>For taxable years beginning in:</th>
<th>The applicable amount is:</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002 through 2005</td>
<td>$500</td>
</tr>
<tr>
<td>2008 and thereafter</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

(C) COST-OF-LIVING ADJUSTMENT.—

(i) IN GENERAL.—In the case of any taxable year beginning in a calendar year after 2008, the $5,000 amount under subparagraph (A) shall be increased by an amount equal to—

(I) such dollar amount, multiplied by

(II) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, determined by substituting 'calendar year 2007' for 'calendar year 1992' in subparagraph (B) thereof.

(ii) ROUNDING RULES.—If any amount after adjustment under clause (i) is not a multiple of $500, such
amount shall be rounded to the next lower multiple of $500.”.

(b) CONFORMING AMENDMENTS.—

(1) Section 408(a)(1) is amended by striking “in excess of $2,000 on behalf of any individual” and inserting “on behalf of any individual in excess of the amount in effect for such taxable year under section 219(b)(1)(A)”.

(2) Section 408(b)(2)(B) is amended by striking “$2,000” and inserting “the dollar amount in effect under section 219(b)(1)(A)”.

(3) Section 408(b) is amended by striking “$2,000” in the matter following paragraph (4) and inserting “the dollar amount in effect under section 219(b)(1)(A)”.

(4) Section 408(j) is amended by striking “$2,000”.

(5) Section 408(p)(8) is amended by striking “$2,000” and inserting “the dollar amount in effect under section 219(b)(1)(A)”.

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2001.

SEC. 602. DEEMED IRAS UNDER EMPLOYER PLANS.

(a) IN GENERAL.—Section 408 (relating to individual retirement accounts) is amended by redesignating subsection (q) as subsection (r) and by inserting after subsection (p) the following new subsection:

"(q) DEEMED IRAS UNDER QUALIFIED EMPLOYER PLANS.—

"(1) GENERAL RULE.—If—

"(A) a qualified employer plan elects to allow employees to make voluntary employee contributions to a separate account or annuity established under the plan, and

"(B) under the terms of the qualified employer plan, such account or annuity meets the applicable requirements of this section or section 408A for an individual retirement account or annuity,

then such account or annuity shall be treated for purposes of this title in the same manner as an individual retirement plan and not as a qualified employer plan (and contributions to such account or annuity as contributions to an individual retirement plan and not to the qualified employer plan). For purposes of subparagraph (B), the requirements of subsection (a)(5) shall not apply.

"(2) SPECIAL RULES FOR QUALIFIED EMPLOYER PLANS.—For purposes of this title, a qualified employer plan shall not fail to meet any requirement of this title solely by reason of establishing and maintaining a program described in paragraph (1).

"(3) DEFINITIONS.—For purposes of this subsection—

"(A) QUALIFIED EMPLOYER PLAN.—The term ‘qualified employer plan’ has the meaning given such term by section 72(p)(4); except such term shall not include a government plan which is not a qualified plan unless the plan is an eligible deferred compensation plan (as defined in section 457(b)).

"(B) VOLUNTARY EMPLOYEE CONTRIBUTION.—The term ‘voluntary employee contribution’ means any contribution (other than a mandatory contribution within the meaning of section 411(c)(2)(C))—
“(i) which is made by an individual as an employee under a qualified employer plan which allows employees to elect to make contributions described in paragraph (1), and
“(ii) with respect to which the individual has designated the contribution as a contribution to which this subsection applies.”.

(b) AMENDMENT OF ERISA.—

(1) IN GENERAL.—Section 4 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1003) is amended by adding at the end the following new subsection:
“(c) If a pension plan allows an employee to elect to make voluntary employee contributions to accounts and annuities as provided in section 408(q) of the Internal Revenue Code of 1986, such accounts and annuities (and contributions thereto) shall not be treated as part of such plan (or as a separate pension plan) for purposes of any provision of this title other than section 403(c), 404, or 405 (relating to exclusive benefit, and fiduciary and co-fiduciary responsibilities).”.

(2) CONFORMING AMENDMENT.—Section 4(a) of such Act (29 U.S.C. 1003(a)) is amended by inserting “or (c)” after “subsection (b)”.

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to plan years beginning after December 31, 2002.
APPENDIX F:
ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001: COMMITTEE REPORT

VI. PENSION AND INDIVIDUAL RETIREMENT ARRANGEMENT PROVISIONS 55

A. INDIVIDUAL RETIREMENT ARRANGEMENTS ("IRAs") (Sec. 101 of the House bill, Secs. 601–603 of the Senate amendment and Secs. 219, 408, and 408A of the Code)

PRESENT LAW

In general

There are two general types of individual retirement arrangements ("IRAs") under present law: traditional IRAs, to which both deductible and nondeductible contributions may be made, and Roth IRAs. The Federal income tax rules regarding each type of IRA (and IRA contribution) differ.

Traditional IRAs

Under present law, an individual may make deductible contributions to an IRA up to the lesser of $2,000 or the individual’s compensation if neither the individual nor the individual’s spouse is an active participant in an employer-sponsored retirement plan. In the case of a married couple, deductible IRA contributions of up to $2,000 can be made for each spouse (including, for example, a homemaker who does not work outside the home), if the combined compensation of both spouses is at least equal to the contributed amount. If the individual (or the individual’s spouse) is an active participant in an employer-sponsored retirement plan, the $2,000

55 The provisions of the bill as passed by the House did not contain provisions relating to pensions and individual retirement arrangements. Provisions described under the House bill refer to the provisions of H.R. 10, the "Comprehensive Retirement Security and Pension Reform Act of 2001," as passed by the House.
deduction limit is phased out for taxpayers with adjusted gross income ("AGI") over certain levels for the taxable year.

The AGI phase-out limits for taxpayers who are active participants in employer-sponsored plans are as follows.

**Single Taxpayers**

<table>
<thead>
<tr>
<th>Taxable years beginning in:</th>
<th>Phase-out range</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>$33,000–43,000</td>
</tr>
<tr>
<td>2002</td>
<td>34,000–44,000</td>
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<tr>
<td>2003</td>
<td>40,000–50,000</td>
</tr>
<tr>
<td>2004</td>
<td>45,000–55,000</td>
</tr>
<tr>
<td>2005 and thereafter</td>
<td>50,000–60,000</td>
</tr>
</tbody>
</table>

**Joint Returns**

<table>
<thead>
<tr>
<th>Taxable years beginning in:</th>
<th>Phase-out range</th>
</tr>
</thead>
<tbody>
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<td>2001</td>
<td>$53,000–63,000</td>
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<tr>
<td>2002</td>
<td>54,000–64,000</td>
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<tr>
<td>2003</td>
<td>60,000–70,000</td>
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<tr>
<td>2004</td>
<td>66,000–76,000</td>
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<tr>
<td>2005</td>
<td>70,000–80,000</td>
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<tr>
<td>2006</td>
<td>75,000–85,000</td>
</tr>
<tr>
<td>2007 and thereafter</td>
<td>80,000–100,000</td>
</tr>
</tbody>
</table>

The AGI phase-out range for married taxpayers filing a separate return is $0 to $10,000.

If the individual is not an active participant in an employer-sponsored retirement plan, but the individual’s spouse is, the $2,000 deduction limit is phased out for taxpayers with AGI between $150,000 and $160,000.

To the extent an individual cannot or does not make deductible contributions to an IRA or contributions to a Roth IRA, the individual may make nondeductible contributions to a traditional IRA.

Amounts held in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal is a return of nondeductible contributions). Includible amounts withdrawn prior to attainment of age 59 ½ are subject to an additional 10-percent early withdrawal tax, unless the withdrawal is due to death or disability, is made in the form of certain periodic payments, is used to pay medical expenses in excess of 7.5 percent of AGI, is used to purchase health insurance of an unemployed individual, is used for education expenses, or is used for first-time homebuyer expenses of up to $10,000.

**Roth IRAs**

Individuals with AGI below certain levels may make nondeductible contributions to a Roth IRA. The maximum annual contribution that may be made to a Roth IRA is the lesser of $2,000 or the individual’s compensation for the year. The contribution limit is reduced to the extent an individual makes contributions to any other IRA for the same taxable year. As under the rules relating to IRAs generally, a contribution of up to $2,000 for each spouse may be made to a Roth IRA provided the combined compensation of the spouses is at least equal to the contributed amount. The maximum annual contribution that can be made to a Roth IRA is phased out for single individuals with AGI between $95,000 and $110,000 and for joint filers with AGI between $150,000 and $160,000.
Appendix

Taxpayers with modified AGI of $100,000 or less generally may convert a traditional IRA into a Roth IRA. The amount converted is includible in income as if a withdrawal had been made, except that the 10-percent early withdrawal tax does not apply and, if the conversion occurred in 1998, the income inclusion may be spread ratably over four years. Married taxpayers who file separate returns cannot convert a traditional IRA into a Roth IRA.

Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income, or subject to the additional 10-percent tax on early withdrawals. A qualified distribution is a distribution that (1) is made after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) which is made after attainment of age 59½, on account of death or disability, or is made for first-time homebuyer expenses of up to $10,000.

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings, and subject to the 10-percent early withdrawal tax (unless an exception applies). The same exceptions to the early withdrawal tax that apply to IRAs apply to Roth IRAs.

Taxation of charitable contributions

Generally, a taxpayer who itemizes deductions may deduct cash contributions to charity, as well as the fair market value of contributions of property. The amount of the deduction otherwise allowable for the taxable year with respect to a charitable contribution may be reduced, depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.

For donations of cash by individuals, total deductible contributions to public charities may not exceed 50 percent of a taxpayer's adjusted gross income ("AGI") for a taxable year. To the extent a taxpayer has not exceeded the 50-percent limitation, contributions of cash to private foundations and certain other nonprofit organizations and contributions of capital gain property to public charities generally may be deducted up to 30 percent of the taxpayer's AGI. If a taxpayer makes a contribution in one year that exceeds the applicable 50-percent or 30-percent limitation, the excess amount of the contribution may be carried over and deducted during the next five taxable years.

In addition to the percentage limitations imposed specifically on charitable contributions, present law imposes a reduction on most itemized deductions, including charitable contribution deductions, for taxpayers with adjusted gross income in excess of a threshold amount, which is adjusted annually for inflation. The threshold amount for 2001 is $132,950 ($66,475 for married individuals filing separate returns). For those deductions that are subject to the limit, the total amount of itemized deductions is reduced by three percent of AGI over the threshold amount, but not by more than 80 percent of itemized deductions subject to the limit.

56 Early distribution of converted amounts may also accelerate income inclusion of converted amounts that are taxable under the four-year rule applicable to 1998 conversions.
The effect of this reduction may be to limit a taxpayer’s ability to deduct some of his or her charitable contributions.

**HOUSE BILL**

*Increase in annual contribution limits*

The House bill increases the maximum annual dollar contribution limit for IRA contributions from $2,000 to $3,000 in 2002, $4,000 in 2003, and $5,000 in 2004. The limit is indexed in $500 increments in 2005 and thereafter.

*Additional catch-up contributions*

The House bill accelerates the increase of the IRA maximum contribution limit for individuals who have attained age 50 before the end of the taxable year. The maximum dollar contribution limit (before application of the AGI phase-out limits) for such an individual is increased to $5,000 in 2002 and 2003. In 2004 and thereafter, the general limit applies to all individuals.

*Deemed IRAs under qualified plans*

No provision.

*Tax-free IRA withdrawals for charitable purposes*

No provision.

*Effective date.*—The provision is effective for taxable years beginning after December 31, 2001.

**SENATE AMENDMENT**

*Increase in annual contribution limits*

The Senate amendment increases the maximum annual dollar contribution limit for IRA contributions from $2,000 to $2,500 for 2002 through 2005, $3,000 for 2006 and 2007, $3,500 for 2008 and 2009, $4,000 for 2010, and $5,000 for 2011. After 2011, the limit is adjusted annually for inflation in $500 increments.

*Additional catch-up contributions*

The Senate amendment provides that individuals who have attained age 50 may make additional catch-up IRA contributions. The otherwise maximum contribution limit (before application of the AGI phase-out limits) for an individual who has attained age 50 before the end of the taxable year is increased by $500 for 2002 through 2005, $1,000 for 2006 through 2009, $1,500 for 2010, and $2,000 for 2011 and thereafter.

*Deemed IRAs under employer plans*

The Senate amendment provides that, if an eligible retirement plan permits employees to make voluntary employee contributions to a separate account or annuity that (1) is established under the plan, and (2) meets the requirements applicable to either traditional IRAs or Roth IRAs, then the separate account or annuity is deemed a traditional IRA or a Roth IRA, as applicable, for all purposes of the Code. For example, the reporting requirements applicable to IRAs apply. The deemed IRA, and contributions thereto, are not subject to the Code rules pertaining to the eligible retire-
ment plan. In addition, the deemed IRA, and contributions thereto, are not taken into account in applying such rules to any other contributions under the plan. The deemed IRA, and contributions thereto, are subject to the exclusive benefit and fiduciary rules of ERISA to the extent otherwise applicable to the plan, and are not subject to the ERISA reporting and disclosure, participation, vesting, funding, and enforcement requirements applicable to the eligible retirement plan.\textsuperscript{57} An eligible retirement plan is a qualified plan (sec. 401(a)), tax-sheltered annuity (sec. 403(b)), or a governmental section 457 plan.

\textbf{Tax-free IRA withdrawals for charitable purposes}

The Senate amendment provides an exclusion from gross income for qualified charitable distributions from an IRA: (1) to a charitable organization (as described in sec. 170(c)) to which deductible contributions may be made; (2) to a charitable remainder annuity trust or charitable remainder unitrust; (3) to a pooled income fund (as defined in sec. 642(c)(5)); or (4) for the issuance of a charitable gift annuity. The exclusion applies with respect to distributions described in (2), (3), or (4) only if no person holds an income interest in the trust, fund, or annuity attributable to such distributions other than the IRA owner, his or her spouse, or a charitable organization.

In determining the character of distributions from a charitable remainder annuity trust or a charitable remainder unitrust to which a qualified charitable distribution from an IRA is made, the charitable remainder trust is required to treat as ordinary income the portion of the distribution from the IRA to the trust which would have been includible in income but for the Senate amendment, and as corpus any remaining portion of the distribution. Similarly, in determining the amount includible in gross income by reason of a payment from a charitable gift annuity purchased with a qualified charitable distribution from an IRA, the taxpayer is not permitted to treat the portion of the distribution from the IRA that would have been taxable but for the Senate amendment and that is used to purchase the annuity as an investment in the annuity contract.

A qualified charitable distribution is any distribution from an IRA that is made after age 70 1/2, that qualifies as a charitable contribution (within the meaning of sec. 170(c)), and that is made directly to the charitable organization or to a charitable remainder annuity trust, charitable remainder unitrust, pooled income fund, or charitable gift annuity (as described above).\textsuperscript{58} A taxpayer is not permitted to claim a charitable contribution deduction for amounts transferred from his or her IRA to a charity or to a trust, fund, or annuity that, because of the Senate amendment, are excluded from the taxpayer's income. Conversely, if the amounts transferred are

\textsuperscript{57} The Senate amendment does not specify the treatment of deemed IRAs for purposes other than the Code and ERISA.

\textsuperscript{58} It is intended that, in the case of transfer to a trust, fund, or annuity, the full amount distributed from an IRA will meet the definition of a qualified charitable distribution if the charitable organization's interest in the distribution would qualify as a charitable contribution under section 170.
otherwise nontaxable, e.g., a qualified distribution from a Roth IRA, the regularly applicable deduction rules apply.

**Effective date.**—The Senate amendment is generally effective for taxable years beginning after December 31, 2001. The provision relating to deemed IRAs under employer plans is effective for plan years beginning after December 31, 2002. The provision relating to tax-free IRA withdrawals for charitable purposes is effective for taxable years beginning after December 31, 2009.

**CONFERENCE AGREEMENT**

*Increase in annual contribution limits*

The conference agreement increases the maximum annual dollar contribution limit for IRA contributions from $2,000 to $3,000 for 2002 through 2004, $4,000 for 2005 through 2007, and $5,000 for 2008. After 2008, the limit is adjusted annually for inflation in $500 increments.

*Additional catch-up contributions*

The conference agreement provides that individuals who have attained age 50 may make additional catch-up IRA contributions. The otherwise maximum contribution limit (before application of the AGI phase-out limits) for an individual who has attained age 50 before the end of the taxable year is increased by $500 for 2002 through 2005, and $1,000 for 2006 and thereafter.

*Deemed IRAs under employer plans*

The conference agreement follows the Senate amendment.

*Tax-free IRA withdrawals for charitable purposes*

The conference agreement does not include the Senate amendment.

**Effective date.**—The conference agreement is generally effective for taxable years beginning after December 31, 2001. The provision relating to deemed IRAs under employer plans is effective for plan years beginning after December 31, 2002.
type that does not individually or cumulatively have a significant effect on the human environment. Therefore, neither an environmental assessment nor an environmental impact statement is required.

List of Subjects in 21 CFR Part 558
Animal drugs, Animal feeds.

Therefore, under the Federal Food, Drug, and Cosmetic Act and under authority delegated to the Commissioner of Erotic Drugs, and redelegated to the Center for Veterinary Medicine, 21 CFR part 558 is amended as follows:

PART 558—NEW ANIMAL DRUGS FOR USE IN ANIMAL FEEDS

1. The authority citation for 21 CFR part 558 continues to read as follows:

2. Section 558.355 is amended in paragraph (b)(11) by deleting "and (xxv)" and adding in its place "(xxv), (xxvi), (xxvii), and (xxviii)" and by adding paragraphs (h)(1)(xxvii) and (h)(1)(xxviii) to read as follows:

§558.355 Moneisn.

(a) Indications for use. As an aid in the control of necrotic enteritis caused or complicated by Clostridium spp. or other organisms susceptible to bacitracin methylene disalicylate; as an aid in the prevention of coccidiosis caused by Eimeria tenella, E. necatrix, E. acervulina, E. maxima, E. brunetti, and E. mitivitt; for increased rate of weight gain.
(b) Limitations. For broiler chickens only. Feed continuously as sole ration. Use as sole source of organic arsenic. Withdraw 5 days before slaughter. Do not feed to laying hens. To control necrotic enteritis, start medication at first clinical signs of disease. The dosage range permitted provides for different levels based on the severity of infection. Use continuously for 5 to 7 days or as long as clinical signs persist, then reduce dosage to prevention level.

3. Section 558.355 is amended in paragraph (h)(1) by deleting "(b) (xxv)" and adding in its place "(b) (xxvi)"

(b) Amount per ton. Moneisn 90 to 110 grams plus bacitracin 100 to 200 grams and roxarsone 22.7 to 34.0 grams.

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 1998, 1999. 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 response/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 the 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 recharactrized. 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 tax-free distribution of certain excess traditional IRA contributions after the owner’s Federal income tax return due date do not apply to Roth IRAs because Roth IRA contributions are always tax-free on distribution (except to the extent that they accelerate income inclusion under the 4-year spread). Similarly, section 219(f)(5), 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)(5)(ii)(III). The final regulations provide that the surviving spouse must acquire the “entire interest” in any Roth IRA to which a conversion contribution applies if the surviving spouse is “properly 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(r). 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(r) 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 70½, 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 1/2 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 traditional IRAs, but not in the case of rollover IRAs or rollover rollover. Including such a distribution for the year that the individual reaches age 70 1/2, because, pursuant to section 408(a)(9)(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 1/2. These commentators argued that, under section 401(a)(9), distributions made during the calendar year in which the IRA owner reaches age 70 1/2 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 1/2, 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 transfer of an 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 employee or employer 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 is 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 filling 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. After IRA that is converted to a Roth IRA and subsequently recharacterized back to a traditional IRA. The IRS and Treasury regulations suggested that a Roth IRA subsequent to a traditional IRA retains its status as a conduit IRA because of 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 subject to withholding. The final regulations also provide rules regarding the “reconversion” of an IRA. Before having been transferred from a Roth IRA to a traditional IRA by means of a recharacterization after having 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 to a traditional IRA and whether it is necessary to track the source of assets (i.e., as employee or employer 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 is 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 filling 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
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 conversion 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 the 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 reversion 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 reversion 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 “excess reconversion” and does not change the IRA owner’s taxable conversion amount. Instead, the excess reconversion and the last preceding recharacterization 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-year 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-year taxable 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 404B(5); 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. Voht, 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. 408.
§ 1.408A-2 also issued under 26 U.S.C. 408.
§ 1.408A-3 also issued under 26 U.S.C. 408.
§ 1.408A-4 also issued under 26 U.S.C. 408.
§ 1.408A-5 also issued under 26 U.S.C. 408.
§ 1.408A-6 also issued under 26 U.S.C. 408.
§ 1.408A-7 also issued under 26 U.S.C. 408.
§ 1.408A-8 also issued under 26 U.S.C. 408.
§ 1.408A-9 also issued under 26 U.S.C. 408.

Par. 2. Sections 1.408A-0 through 1.408A-9 are added to read as follows:

§ 1.408A-0 Roth IRAs; table of contents.
This table of contents lists the regulations relating to Roth IRAs under section 408A of the Internal Revenue Code as follows:
§ 1.408A-1 Roth IRAs in general.
§ 1.408A-2 Establishing Roth IRAs.
§ 1.408A-3 Contributions to Roth IRAs.
§ 1.408A-4 Converting amounts to Roth IRAs.
§ 1.408A-5 Recharacterized contributions.
§ 1.408A-6 Distributions.
§ 1.408A-7 Reporting.
§ 1.408A-8 Definitions.

§ 1.408A-9 Effective date.

§ 1.408A-1 Roth IRAs in general.
This section sets forth the following questions and answers that discuss the background and general features of Roth IRAs.
Q-1. What is a Roth IRA?
A-1. (a) A Roth IRA is a new type of individual retirement plan that individuals can use, beginning in 1998. Roth IRAs are described in section 408A, which was added by the Taxpayer Relief Act of 1997 (TRA 97), Public Law 105-34 (111 Stat. 788).
(b) Roth IRAs are treated like traditional IRAs except where the Internal Revenue Code specifies different treatment. For example, aggregate contributions (other than by a converter or other rollover) to all an individual’s Roth IRAs are not permitted to exceed $2,000 for a taxable year. Further, income earned on funds held in a Roth IRA is generally not taxable. Similarly, the rules of section 408(e), such as the loss of exemption of the account where the owner engages in a prohibited transaction, apply to Roth IRAs in the same manner as to traditional IRAs.
Q-2. What are the significant differences between traditional IRAs and Roth IRAs?
A-2. There are several significant differences between traditional IRAs and Roth IRAs.
Q-3. Can an employer or an association of employees establish a Roth IRA to hold contributions of employees or members?
A-3. Yes. Pursuant to section 408(c), an employer or an association of employees can establish a trust to hold contributions of employees or members made under a Roth IRA. Each employee’s or member’s account in the trust is treated as a separate Roth IRA that is subject to the generally applicable Roth IRA rules. The employer or association of employees may do certain acts otherwise required by an individual, for example, establishing and designating a trust as a Roth IRA.
Q-4. What is the effect of a surviving spouse of a Roth IRA owner treating an IRA as his or her own?
A-4. If the surviving spouse of a Roth IRA owner treats a Roth IRA as his or her own as of a date, the Roth IRA is treated from that date forward as though it were established for the benefit of the surviving spouse and not the original Roth IRA owner. Thus, for example, the surviving spouse is treated as the Roth IRA owner for purposes of applying the minimum distribution requirements under section 408(a)(6) and (b)(3). Similarly, the surviving spouse is treated as the Roth IRA owner rather than a beneficiary for purposes of determining the amount of any distribution from the Roth IRA that is includible in gross income and whether the distribution is subject to the 10-percent additional tax under section 72(t).

§ 1.408A-3 Contributions to Roth IRAs.
This section sets forth the following questions and answers that provide rules regarding contributions to Roth IRAs:
Q-1. What types of contributions are permitted to be made to a Roth IRA?
A-1. There are two types of contributions that are permitted to be
made to a Roth IRA: regular contributions and qualified rollover contributions (including conversion contributions). The term regular contributions means contributions other than qualified rollover contributions.

Q-2. When are contributions permitted to be made to a Roth IRA?

A-2. (a) The provisions of section 408A are effective for taxable years beginning on or after January 1, 1998. Thus, the first taxable year for which contributions are permitted to be made to a Roth IRA by an individual is the individual’s taxable year beginning in 1998.

(b) Regular contributions for a particular taxable year must generally be contributed by the due date (not including extensions) for filing a Federal income tax return for that taxable year. (See §1.408A-5 regarding recharacterization of certain contributions.)

Q-3. What is the maximum aggregate amount of regular contributions an individual is eligible to contribute to a Roth IRA for a taxable year?

A-3. (a) The maximum aggregate amount that an individual is eligible to contribute to all his or her Roth IRAs as a regular contribution for a taxable year is the same as the maximum for traditional IRAs: $2,000 or, if less, that individual’s compensation for the year.

(b) For Roth IRAs, the maximum amount described in paragraph (a) of this A-3 is phased out between certain levels of modified AGI. For an individual who is not married, the dollar amount is phased out ratably between modified AGI of $95,000 and $110,000; for a married individual filing a joint return, between modified AGI of $150,000 and $160,000; and for a married individual filing separately, between modified AGI of $50 and $10,000. For this purpose, a married individual who has lived apart from his or her spouse for the entire taxable year and who files separately is treated as not married. Under section 408A(c)(3)(A), in applying the phase-out, the maximum amount is rounded up to the next higher multiple of $10 and is not reduced below $200 until completely phased out.

(c) If an individual makes regular contributions to both traditional IRAs and Roth IRAs for a taxable year, the maximum limit for the Roth IRA is the lesser of:

(1) The amount described in paragraph (a) of this A-3 reduced by the amount contributed to traditional IRAs for the taxable year; and

(2) The amount described in paragraph (b) of this A-3.

Employer contributions, including elective deferrals, made under a SEP or SIMPLE IRA Plan on behalf of an individual (including a self-employed individual) do not reduce the amount of the individual’s maximum regular contribution.

(d) The rules in this A-3 are illustrated by the following examples:

Example 1. In 1998, unmarried, calendar-year taxpayer B, age 60, has modified AGI of $40,000 and compensation of $5,000. For 1998, B can contribute a maximum of $2,000 to a traditional IRA, a Roth IRA or a combination of traditional and Roth IRAs.

Example 2. The facts are the same as in Example 1. However, assume that B violates the maximum regular contribution limit by contributing $2,000 to a traditional IRA and $2,000 to a Roth IRA for 1998. The $2,000 to B’s Roth IRA would be an excess contribution to B’s Roth IRA for 1998 because an individual’s contributions are applied first to a traditional IRA, then to a Roth IRA.

Example 3. The facts are the same as in Example 1, except that B’s compensation is $900. The maximum amount B can contribute to either a traditional IRA or a Roth (or a combination of the two) for 1998 is $900.

Example 4. In 1998, unmarried, calendar-year taxpayer C, age 60, has modified AGI of $100,000 and compensation of $5,000. For 1998, C contributes $800 to a traditional IRA and $1,200 to a Roth IRA. Because C’s $1,200 Roth IRA contribution does not exceed the phase-out maximum Roth IRA contribution of $1,540 and because C’s total IRA contributions do not exceed $2,000, C’s Roth IRA contribution does not exceed the maximum permissible contribution.

Q-4. How is compensation defined for purposes of the Roth IRA contribution limit?

A-4. For purposes of the contribution limit described in A-3 of this section, an individual’s compensation is the same as that used to determine the maximum contribution an individual can make to a traditional IRA. This amount is defined in section 219(f)(1) to include wages, commissions, professional fees, tips, and other amounts received for personal services, as well as taxable alimony and separate maintenance payments received under a decree of divorce or separate maintenance. Compensation also includes earned income as defined in section 401(c)(2), but does not include any amount received as a pension or annuity or as deferred compensation. In addition, under section 219(c), a married individual filing a joint return is permitted to make an IRA contribution by treating his or her spouse’s higher compensation as his or her own, but only to the extent that the spouse’s compensation is not being used for purposes of the spouse making a contribution to a Roth IRA or a deductible contribution to a traditional IRA.

Q-5. What is the significance of modified AGI and how is it determined?

A-5. Modified AGI is used for purposes of the phase-out rules described in A-3 of this section and for purposes of the $100,000 modified AGI limitation described in §1.408A-4 A-2(a) (relating to eligibility for conversion). As defined in section 408A(c)(3)(C)(i), modified AGI is the same as adjusted gross income under section 219 and thus does not apply in determining modified AGI for Roth IRA purposes.

Q-6. Is a required minimum distribution from an IRA for a year included in income for purposes of determining modified AGI?

A-6. (a) Yes. For taxable years beginning after December 31, 2004, and solely for purposes of the $100,000 limitation applicable to conversions, modified AGI does not include any required minimum distributions from an IRA under section 408(a)(6) and (b)(3) (which generally incorporate the provisions of section 401(a)(9)) is included in income for purposes of determining modified AGI.

(b) For taxable years beginning after December 31, 2004, and solely for purposes of the $100,000 limitation applicable to conversions, modified AGI does not include any required minimum distributions from an IRA for a year included in income for purposes of determining modified AGI.

Q-7. Does an excise tax apply if an individual exceeds the aggregate regular contribution limits for Roth IRAs?

A-7. Yes. Section 4973 imposes an annual 6-percent excise tax on aggregate amounts contributed to Roth IRAs that exceed the maximum contribution limits described in A-3 of this section. Any contribution that is distributed, together with net income, from a Roth IRA on or before the tax return due date (with extensions) for the taxable year in which the contribution is made. Aggregate excess contributions that are not distributed from a Roth IRA on or before the tax return due date (with extensions) for the taxable year of the contributions are reduced as a deemed Roth IRA contribution for each
subsequent taxable year to the extent that the Roth IRA owner does not actually make regular IRA contributions for such years. Section 4973 applies separately to an individual’s Roth IRAs and other types of IRAs.

§ 1.408A-4 Converting amounts to Roth IRAs.

This section sets forth the following questions and answers that provide rules applicable to Roth IRA conversions:

Q-1. Can an individual convert an amount in his or her traditional IRA to a Roth IRA?

A-1. (a) Yes. An amount in a traditional IRA may be converted to an amount in a Roth IRA if two requirements are satisfied. First, the IRA owner must satisfy the modified AGI limitation described in A-2(a) of this section and, if married, the joint filing requirement described in A-2(b) of this section. Second, the amount contributed to the Roth IRA must satisfy the definition of a qualified rollover contribution in section 408A(e) (i.e., it must satisfy the requirements for a rollover contribution as defined in section 408(d)(3), except that the one-rollover-per-year limitation in section 408(d)(3)(B) does not apply).

(b) An amount can be converted by any of three methods—

(1) An amount distributed from a traditional IRA is contributed (rolled over) to a Roth IRA within the 60-day period described in section 408(d)(3)(A)(i);

(2) An amount in a traditional IRA is transferred in a trustee-to-trustee transfer from the trustee of the traditional IRA to the trustee of the Roth IRA; or

(3) An amount in a traditional IRA is transferred to a Roth IRA maintained by the same trustee. For purposes of sections 408 and 408A, redesignating a traditional IRA as a Roth IRA is treated as a transfer of the entire account balance from a traditional IRA to a Roth IRA.

(c) Any converted amount is treated as a distribution from the traditional IRA and a qualified rollover contribution to the Roth IRA for purposes of section 408 and section 408A, even if the conversion is accomplished by means of a trustee-to-trustee transfer or a transfer between IRAs of the same trustee.

(d) A transaction that is treated as a failed conversion under § 1.408A-5 A-9(g)(1) is not a conversion.

Q-2. What are the modified AGI limitation and joint filing requirements for conversions?

A-2. (a) An individual with modified AGI in excess of $100,000 for a taxable year is not permitted to convert an amount to a Roth IRA during that taxable year. This $100,000 limitation applies to the taxable year that the funds are paid from the traditional IRA, rather than the year they are contributed to the Roth IRA.

(b) If the individual is married, he or she is permitted to convert an amount to a Roth IRA during a taxable year only if the individual and the individual’s spouse file a joint return for the taxable year that the funds are paid from the traditional IRA. In this case, the modified AGI subject to the $100,00 limit is the modified AGI derived from the joint return using the couple’s combined income. The only exception to this joint filing requirement is for an individual who has lived apart from his or her spouse for the entire taxable year. If the married individual has lived apart from his or her spouse for the entire taxable year, then such individual can treat himself or herself as not married for purposes of this paragraph, file a separate return and be subject to the $100,000 limit on his or her separate modified AGI. In all other cases, a married individual filing a separate return is not permitted to convert an amount to a Roth IRA, regardless of the individual’s modified AGI.

Q-3. Is a remedy available to an individual who makes a failed conversion?

A-3. (a) Yes. See § 1.408A-5 for rules permitting a failed conversion amount to be recharacterized as a contribution to a traditional IRA. If the requirements in § 1.408A-5 are satisfied, the failed conversion amount will be treated as having been contributed to the traditional IRA and not to the Roth IRA.

(b) If the contribution is not recharacterized in accordance with § 1.408A-5, the contribution will be treated as a regular contribution to the Roth IRA and, thus, an excess contribution subject to the excise tax under section 4973 to the extent that it exceeds the individual’s regular contribution limit. This is the result regardless of which of the three methods described in A-1(b) of this section applies to this transaction. Additionally, the distribution from the traditional IRA will not be eligible for the 4-year spread and will be subject to the additional tax under section 72(t) (unless an exception under that section applies).

Q-4. Do any special rules apply to a conversion of an amount in an individual’s SEP IRA or SIMPLE IRA to a Roth IRA?

A-4. (a) An amount in an individual’s SEP IRA can be converted to a Roth IRA on the same terms as an amount in any other traditional IRA.

(b) An amount in an individual’s SIMPLE IRA can be converted to a Roth IRA on the same terms as a conversion from a traditional IRA, except that an amount distributed from a SIMPLE IRA during the 2-year period described in section 72(t)(6), which begins on the date that the individual first participated in any SIMPLE IRA Plan maintained by his or her employer, cannot be converted to a Roth IRA. Pursuant to section 408(d)(3)(C), a distribution of an amount from an individual’s SIMPLE IRA during this 2-year period is not eligible to be rolled over into an IRA that is not a SIMPLE IRA and thus cannot be a qualified rollover contribution. This 2-year period of section 408(d)(3)(C) applies separately to the contributions of each of an individual’s employers maintaining a SIMPLE IRA Plan.

Q-5. Can amounts in other kinds of retirement plans be converted to a Roth IRA?

A-5. No. Only amounts in another IRA can be converted to a Roth IRA. For example, amounts in a qualified plan or annuity plan described in section 401(a) or 403(a) cannot be converted directly to a Roth IRA. Also, amounts held in an annuity contract or account described in section 403(b) cannot be converted directly to a Roth IRA.

Q-6. Can an individual who has attained at least age 70½ by the end of a calendar year convert an amount distributed from a traditional IRA during that year to a Roth IRA before receiving his or her required minimum distribution with respect to the traditional IRA for the year of the conversion?

A-6. (a) No. In order to be eligible for a conversion, an amount first must be eligible to be rolled over. Section 408(d)(3) prohibits the rollover of a required minimum distribution. If a minimum distribution is required for a year with respect to an IRA, the first dollars distributed during that year are treated as consisting of the required minimum distribution until an amount equal to the required minimum distribution for that year has been distributed.

(b) As provided in A-1(c) of this section, any amount converted is treated as a distribution from a traditional IRA and a rollover contribution to a Roth
IRA and not as a trustee-to-trustee transfer for purposes of section 408 and section 408A. Thus, in a year for which a minimum distribution is required (including the calendar year in which the individual attains age 70 1/2), an individual may not convert the assets of an IRA (or any portion of those assets) to a Roth IRA to the extent that the required minimum distribution for the traditional IRA for the year has not been distributed.

(c) If a required minimum distribution is contributed to a Roth IRA, it is treated as having been distributed, subject to the normal rules under section 408(d)(1) and (2), and then contributed as a regular contribution to a Roth IRA. The amount of the required minimum distribution is not a contribution.

Q-7. What are the tax consequences when an amount is converted to a Roth IRA?

A-7. (a) Any amount that is converted to a Roth IRA is includable in gross income as a distribution according to the rules of section 408(d)(1) and (2) for the taxable year in which the amount is distributed or transferred from the traditional IRA. Thus, any portion of the distribution or transfer that is treated as a return of basis under section 408(d)(1) and (2) is not includable in gross income as a result of the conversion.

(b) The 10-percent additional tax under section 72(g) generally does not apply to the taxable conversion amount. But see §1.408A-6 A-5 for circumstances under which the taxable conversion amount would be subject to the additional tax under section 72(g).

(c) Pursuant to section 408A(e), a conversion is not treated as a rollover for purposes of the one-rollover-per-year rule of section 408(d)(3)(B).

Q-8. Is there an exception to the income-inclusion rule described in A-7 of this section for 1998 conversions?

A-8. Yes. In the case of a distribution (including a trustee-to-trustee transfer) from a traditional IRA on or before December 31, 1998, that is converted to a Roth IRA, instead of having the entire taxable conversion amount includible in income in the taxable year in which the distribution occurred, any amount of the distribution contributed to a Roth IRA in 1998 is treated as having been distributed and contributed to the Roth IRA within the 60-day period described in section 408(d)(3)(A)(i), but after December 31, 1998. However, see §1.408A-6 A-6 for special rules requiring acceleration of inclusion if an amount subject to the 4-year spread is distributed from the Roth IRA before 2001.

Q-9. Is the taxable conversion amount included in income for all purposes?

A-9. Except as provided below, any taxable conversion amount includible in gross income for a year as a result of the conversion (regardless of whether the individual is using a 4-year spread) is included in income for all purposes. Thus, for example, it is counted for purposes of determining the taxable portion of social security payments under section 86 and for purposes of determining the phase-out of the $25,000 exemption under section 469 relating to the disallowance of passive activity losses from rental real estate activities. However, as provided in §1.408A-3 A-5, the taxable conversion amount (and any resulting change in other elements of adjusted gross income) is disregarded for purposes of determining modified AGI for section 408A.

Q-10. Can an individual who makes a 1998 conversion elect not to have the 4-year spread apply and instead have the full taxable conversion amount includible in gross income for 1998?

A-10. Yes. Instead of having the taxable conversion amount for a 1998 conversion included over 4 years as provided under A-8 of this section, an individual can elect to include the full taxable conversion amount in income for 1998. The election is made on Form 8606 and cannot be made or changed after the due date (including extensions) for filing the 1998 Federal income tax return.

Q-11. What happens when an individual who is using the 4-year spread dies, files separately, or divorces before the full taxable conversion amount has been included in gross income?

A-11. (a) If an individual who is using the 4-year spread described in A-8 of this section dies before the full taxable conversion amount has been included in gross income, then the remainder must be included in the individual’s gross income for the taxable year that includes the date of death.

(b) However, if the sole beneficiary of all the decedent’s Roth IRAs is the decedent’s spouse, then the spouse can elect to continue the 4-year spread. Thus, the spouse can elect to include in gross income the same amount that the decedent would have included in each of the remaining years of the 4-year period. Where the spouse makes such an election, the amount includible under the 4-year spread for the taxable year that includes the date of the decedent’s death remains includible in the decedent’s gross income and is reported on the decedent’s final Federal income tax return. The election is made on either Form 8806 or Form 1040, in accordance with the instructions to the applicable form, for the taxable year that includes the decedent’s date of death and cannot be changed after the due date (including extensions) for filing the Federal income tax return for the spouse’s taxable year that includes the decedent’s date of death.

(c) If a Roth IRA owner who is using the 4-year spread and who was married in 1998 subsequently files separately or divorces before the full taxable conversion amount has been included in gross income, the remainder of the taxable conversion amount must be included in the Roth IRA owner’s gross income over the remaining years in the 4-year period (unless accelerated because of distribution or death).

Q-12. Can an individual convert a traditional IRA to a Roth IRA if he or she is receiving substantially equal periodic payments within the meaning of section 72(t)(2)(A)(iv) from that traditional IRA?

A-12. Yes. Not only is the conversion amount itself not subject to the early distribution tax under section 72(t), but the conversion amount is also not treated as a distribution for purposes of determining whether a recapture modification within the meaning of section 72(t)(4)(A) has occurred. Distributions from the Roth IRA that are part of the original series of substantially equal periodic payments will be nonqualified distributions from the Roth IRA until they meet the requirements for being a qualified distribution, described in §1.408A-6 A-10. The additional 10-percent tax under section 72(t) will not apply to the extent that these nonqualified distributions are part of a series of substantially equal periodic payments. Nevertheless, to the extent that such distributions are allocable to a 1998 conversion contribution with respect to which the 4-year spread for the resultant income inclusion applies (see A-8 of this section) and are received during 1998, 1999, or 2000, the special acceleration rules of §1.408A-6 A-6 apply. However, if the original series of substantially equal periodic payments does not continue to be distributed in substantially equal periodic payments from the Roth IRA after the conversion, the series of payments will have been modified and, if this modification occurs within 5 years of the first payment or prior to the individual becoming disabled or attaining age 59 1/2, the taxpayer will be subject to the recapture tax of section 72(t)(4)(A).
Q–13. Can a 1997 distribution from a traditional IRA be converted to a Roth IRA in 1998?
A–13. No. An amount distributed from a traditional IRA in 1997 that is contributed to a Roth IRA in 1998 would not be a conversion contribution. See A–3 of this section regarding the remedy for a failed conversion.

§ 1.408A–5 Recharacterized contributions.
This section sets forth the following questions and answers that provide rules regarding recharacterizing IRA contributions.

Q–1. Can an IRA owner recharacterize certain contributions (i.e., treat a contribution made to one type of IRA as made to a different type of IRA) for a taxable year?
A–1. (a) Yes. In accordance with section 408A(d)(6), except as otherwise provided in this section, if an individual makes a contribution to an IRA (the FIRST IRA) for a taxable year and then transfers the contribution (or a portion of the contribution) in a trustee-to-trustee transfer from the trustee of the FIRST IRA to the trustee of another IRA (the SECOND IRA), the individual can elect to treat the contribution as having been made to the SECOND IRA, instead of to the FIRST IRA, for Federal tax purposes.

(b) A transfer between the FIRST IRA and the SECOND IRA will not fail to be a trustee-to-trustee transfer merely because both IRAs are maintained by the same trustee. For purposes of section 408A(d)(6), redesignating the FIRST IRA as the SECOND IRA will be treated as a transfer of the entire account balance from the FIRST IRA to the SECOND IRA.

(c) This recharacterization election can be made only if the trustee-to-trustee transfer from the FIRST IRA to the SECOND IRA is made on or before the due date (including extensions) for filing the individual’s Federal income tax return for the taxable year for which the contribution was made to the FIRST IRA. For purposes of this section, a conversion that is accomplished through a rollover of a distribution from a traditional IRA in a taxable year that, 60 days after the distribution (as described in section 408(d)(3)(A)(ii)), is contributed to a Roth IRA in the next taxable year is treated as a contribution for the earlier taxable year.

Q–2. What is the proper treatment of the net income attributable to the amount of a contribution that is being recharacterized?
A–2. (a) The net income attributable to the amount of a contribution that is being recharacterized must be transferred to the SECOND IRA along with the contribution.

(b) If the amount of the contribution being recharacterized was contributed to a separate IRA and no distributions or additional contributions have been made from or to that IRA at any time, then the contribution is recharacterized by the trustee of the FIRST IRA transferring the entire account balance of the FIRST IRA to the trustee of the SECOND IRA. In this case, the net income (or loss) attributable to the contribution being recharacterized is the difference between the amount of the original contribution and the amount transferred.

(c) If paragraph (b) of this A–2 does not apply, then the net income attributable to the amount of a contribution is calculated in the manner prescribed by § 1.408–4(c)(2)(ii) (disregarding the parenthetical clause in § 1.408–4(c)(6)(i)(ii)).

Q–3. What is the effect of recharacterizing a contribution made to the FIRST IRA as a contribution made to the SECOND IRA?
A–3. The contribution that is being recharacterized as a contribution to the SECOND IRA is treated as having been originally contributed to the SECOND IRA on the same date and (in the case of a regular contribution) for the same taxable year that the contribution was made to the FIRST IRA. Thus, for example, no deduction would be allowed for a contribution to the FIRST IRA, and any net income transferred with the recharacterized contribution is treated as earned in the SECOND IRA, and not the FIRST IRA.

Q–4. Can an amount contributed to an IRA in a tax-free transfer be recharacterized under A–1 of this section?
A–4. No. If an amount is contributed to the FIRST IRA in a tax-free transfer, the amount cannot be recharacterized as a contribution to the SECOND IRA under A–1 of this section. However, if an amount is erroneously rolled over or transferred from a traditional IRA to a SIMPLE IRA, the contribution can subsequently be recharacterized as a contribution to another traditional IRA.

Q–5. Can an amount contributed by an employer under a SIMPLE IRA Plan or a SEP be recharacterized under A–1 of this section?
A–5. No. Employer contributions (including elective deferrals) under a SIMPLE IRA Plan or a SEP cannot be recharacterized as contributions to another IRA under A–1 of this section. However, an amount converted from a SEP IRA or SIMPLE IRA to a Roth IRA may be recharacterized under A–1 of this section as a contribution to a SEP IRA or SIMPLE IRA, including the original SEP IRA or SIMPLE IRA.

Q–6. How does a taxpayer make the election to recharacterize a contribution to an IRA for a taxable year?
A–6. (a) An individual makes the election described in this section by notifying, on or before the date of the transfer, both the trustee of the FIRST IRA and the trustee of the SECOND IRA, that the individual has elected to treat the contribution as having been made to the SECOND IRA, instead of the FIRST IRA, for Federal tax purposes. The notification of the election must include the following information: the type and amount of the contribution to the FIRST IRA that is to be recharacterized, the date on which the contribution was made to the FIRST IRA and the year for which it was made; a direction to the trustee of the FIRST IRA to transfer, in a trustee-to-trustee transfer, the amount of the contribution and net income allocable to the contribution to the trustee of the SECOND IRA; and the names of the trustee of the FIRST IRA and the trustee of the SECOND IRA and any additional information needed to make the transfer.

(b) The election and the trustee-to-trustee transfer must occur on or before the due date (including extensions) for filing the individual’s Federal income tax return for the taxable year for which the recharacterized contribution was made to the FIRST IRA, and the election cannot be revoked after the transfer. An individual who makes this election must report the recharacterization, and must treat the contribution as having been made to the SECOND IRA, instead of the FIRST IRA, on the individual’s Federal income tax return for the taxable year described in the preceding sentence in accordance with the applicable Federal tax forms and instructions.

(c) The election to recharacterize a contribution described in this A–6 may be made on behalf of a deceased IRA owner by his or her executor, administrator, or other person responsible for filing the final Federal income tax return of the decedent under section 6012(d)(1).

Q–7. If an amount is initially contributed to an IRA for a taxable year, then is moved (with net income attributable to the contribution) in a tax-free transfer to another IRA (the FIRST IRA for purposes of A–1 of this section), can the tax-free transfer be disregarded, so that the initial contribution that is transferred from the FIRST IRA to the SECOND IRA is treated as a recharacterization of that initial contribution?
A–7. Yes. In applying section 408A(d)(6), tax-free transfers between IRAs are disregarded. Thus, if a
contribution to an IRA for a year is followed by one or more tax-free transfers between IRAs prior to the recharacterization, then for purposes of section 408(d)(2)(B), the contribution is treated as if it remained in the initial IRA. Consequently, an individual may elect to recharacterize an initial contribution made to the initial IRA that was involved in a series of tax-free transfers by making a trustee-to-trustee transfer from the last IRA in the series to the SECOND IRA. In this case the contribution to the SECOND IRA is treated as made on the same date (and for the same taxable year) as the date the contribution being recharacterized was made to the initial IRA.

Q-8. If a contribution is recharacterized, is the recharacterization treated as a rollover for purposes of the one-rollover-per-year limitation of section 408(d)(2)(B)?

A-8. No, recharacterizing a contribution under A-1 of this section is never treated as a rollover for purposes of the one-rollover-per-year limitation of section 408(d)(2)(B), even if the contribution would have been treated as a rollover contribution by the SECOND IRA if it had been made directly to the SECOND IRA, rather than as a result of a recharacterization of a contribution to the FIRST IRA.

Q-9. If an IRA owner converts an amount from a traditional IRA to a Roth IRA and then transfers that amount back to a traditional IRA in a recharacterization, may the IRA owner subsequently reconvert that amount from the traditional IRA to a Roth IRA? A-9. (a) Except as otherwise provided in paragraph (b) of this A-9, 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 converted amount was treated as 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 (regardless of whether the recharacterization occurs during the taxable year in which the amount was converted to a Roth IRA or the following taxable year). Thus, any attempted reconversion of an amount prior to the time permitted under this paragraph (a) of this A-9 is a failed conversion of that amount.

(c) In determining the portion of any amount held in a Roth IRA or a traditional IRA that an IRA owner may not reconvert under this A-9, any amount previously converted (or reconverted) is adjusted for subsequent net income therefrom.

Q-10. Are there examples to illustrate the rules in this section? A-10. The rules in this section are illustrated by the following examples:

Example 1. In 1998, Individual C converts the entire amount in his traditional IRA to a Roth IRA. Individual C thereafter determines that his modified AGI for 1998 exceeded $100,000 so that he was ineligible to have made a conversion in that year. Accordingly, prior to the due date (plus extensions) for filing the individual's Federal income tax return for 1998, he decides to recharacterize the conversion contribution. He instructs the trustee of the Roth IRA (FIRST IRA) to transfer in a trustee-to-trustee transfer the amount back to his traditional IRA for 1998, as having been previously converted to a Roth IRA and not to the Roth IRA.

Example 2. In 1998, an individual makes a $2,000 regular contribution for 1998 to his traditional IRA (FIRST IRA). Prior to the due date (plus extensions) for filing the individual's Federal income tax return for 1998, he decides that he would prefer to contribute to a Roth IRA instead. The individual instructs the trustee of the FIRST IRA to transfer in a trustee-to-trustee transfer the amount of the contribution, plus attributable net income, to the trustee of a Roth IRA (SECOND IRA). The individual notifies the trustee of the FIRST IRA and the trustee of the SECOND IRA that he is recharacterizing his IRA contribution (and provides the other information described in A-6 of this section). On the individual's Federal income tax return for 1998, he treats the original amount of the conversion as having been contributed to the SECOND IRA and not to the Roth IRA.

Example 3. The facts are the same as in Example 2, except that the $2,000 regular contribution is initially made to a Roth IRA and the recharacterizing transfer is made to a traditional IRA. On the individual's Federal income tax return for 1998, he treats the
2,000 as having been contributed to the traditional IRA for 1998 and not the Roth IRA. As a result, for Federal tax purposes, the contribution is treated as having been made to the traditional IRA for 1998 and not the Roth IRA. The result would be the same if the contribution had been transferred in a tax-free transfer to another Roth IRA prior to the recharacterization, except that the only Roth IRA trustee the individual must notify is the one actually making the recharacterization transfer.

Example 4. In 1998, an individual receives a distribution from traditional IRA 1 and contributes the entire amount to traditional IRA 2 in a rollover contribution described in section 408(d)(3). In this case, the individual cannot elect to recharacterize the contribution by transferring the contribution amount, plus net income, to a Roth IRA, because an amount contributed to an IRA in a tax-free transfer cannot be recharacterized. However, the individual may convert (other than by recharacterization) the amount in traditional IRA 2 to a Roth IRA at any time provided the requirements of §1.408A-4 A-1 are satisfied.

§1.408A-6 Distributions.

This section sets forth the following questions and answers that provide rules regarding distributions from Roth IRAs:

Q-1. How are distributions from Roth IRAs taxed?

An individual is treated as having made a distribution from a Roth IRA generally depends on whether or not the distribution is a qualified distribution. This A-1 provides rules for qualified distributions and certain other nontaxable distributions. A-4 of this section provides rules for the taxability of distributions that are not qualified distributions.

(b) A distribution from a Roth IRA is not includable in the owner's gross income if it is a qualified distribution or to the extent that it is a return of the owner's contributions to the Roth IRA (determined in accordance with A-8 of this section). A qualified distribution is one that is both:

(1) Made after a 5-taxable-year period (defined in A-2 of this section); and

(2) Made on or after the date on which the owner attains age 59 1/2, made to a beneficiary or the estate of the owner on or after the date of the owner's death, attributable to the owner's being disabled within the meaning of section 72(m)(7), or to which section 72(t)(2)(F) applies (exception for first-time home purchase).

(c) An amount distributed from a Roth IRA that is treated as includable in gross income to the extent it is rolled over to another Roth IRA on a tax-free basis under the rules of sections 408(d)(3) and 408A(e).

(d) Contributions that are returned to the Roth IRA owner in accordance with section 408(d)(4) (corrective distributions) are not includable in gross income, but any net income required to be distributed because of section 408(d)(4) together with the contributions is includable in gross income for the taxable year in which the contributions were made.

Q-2. When does the 5-taxable-year period described in A-1 of this section (relating to qualified distributions) begin and end?

A-2. The 5-taxable-year period described in A-1 of this section begins on the first day of the individual's taxable year for which the first regular contribution is made to any Roth IRA of the individual or, if earlier, the first day of the individual's taxable year in which the first conversion contribution is made to any Roth IRA of the individual.

The 5-taxable-year period ends on the last day of the individual's fifth consecutive taxable year beginning with the taxable year described in the preceding sentence. For example, if an individual whose taxable year is the calendar year makes a first-time regular contribution any time between January 1, 1998, and April 15, 1999, for 1998, the 5-taxable-year period begins on January 1, 1998. Thus, each Roth IRA owner has only one 5-taxable-year period described in A-1 of this section for all the Roth IRAs of which he or she is the owner. Further, because of the requirement of the 5-taxable-year period, no qualified distributions can occur before taxable years beginning in 2003. For purposes of this section, if a distribution is made within the 5-taxable-year period beginning with the first day of the individual's taxable year in which the conversion distribution is made, the 5-taxable-year period ends on the last day of the individual's fifth consecutive taxable year beginning with the taxable year described in the preceding sentence. For purposes of applying the tax, only the amount of the conversion distribution includable in gross income as a result of the conversion is taken into account. The exceptions under section 72(t) also apply to such a distribution.

(c) The 5-taxable-year period described in this A-5 for purposes of determining whether section 72(t) applies to a distribution allocable to a conversion contribution is separately determined for each conversion contribution, and need not be the same as the 5-taxable-year period used for purposes of determining whether a distribution is a qualified distribution under section 72(t) of this section.

For example, if a calendar-year taxpayer who received a distribution from a traditional IRA on December 31, 1998, makes a conversion contribution by contributing the distributed amount to a Roth IRA on February 25, 1999 in a qualifying rollover contribution and makes a regular contribution for 1998 on the same date, the 5-taxable-year period for purposes of this A-5 begins on
January 1, 1999, while the 5-taxable-year period for purposes of A–1(b) of this section begins on January 1, 1998.

Q–6. Is there a special rule for taxing distributions allocable to a 1998 conversion?

A–6. Yes. In the case of a distribution from a Roth IRA if 1998, 1999 or 2000 of amounts allocable to a 1998 conversion with respect to which the 4-year spread for the resultant income, included in gross income of the year of the distribution allocable to the 1998 conversion (determined under A–8 of this section). This amount is in addition to the amount otherwise includible in the owner’s gross income for that taxable year as a result of the conversion. However, this rule will not require the inclusion of any amount to the extent it exceeds the total amount of income required to be included over the 4-year period. The acceleration of income included in described in A–6 applies in the case of a surviving spouse who elects to continue the 4-year spread in accordance with §1.408A–4 A–11(b).

Q–7. Is the 5-taxable-year period described in A–1 of this section redefined when a Roth IRA owner dies?

A–7. (a) No. The beginning of the 5-taxable-year period described in A–1 of this section is not redefined when the Roth IRA owner dies. Thus, in determining the 5-taxable-year period, the period the Roth IRA is held in the name of a beneficiary, or in the name of a surviving spouse who treats the deceased’s Roth IRA as his or her own, includes the period it was held by the decedent.

(b) The 5-taxable-year period for a Roth IRA held by an individual as a beneficiary of a deceased Roth IRA owner is determined independently of the 5-taxable-year period for the beneficiary’s own Roth IRA. However, if a surviving spouse treats the Roth IRA as his or her own, the 5-taxable-year period with respect to any of the surviving spouse’s Roth IRAs (including the one that the surviving spouse treats as his or her own) ends at the earlier of the end of either the 5-taxable-year period for the decedent or the 5-taxable-year period allocable to the spouse’s own Roth IRAs.

Q–8. How is it determined whether an amount distributed from a Roth IRA is treated as conversion contributions, or earnings?

A–8. (a) Any amount distributed from an individual’s Roth IRA is treated as made in the following order (determined as of the end of a taxable year and exhausting each category before moving to the following category):

(1) From regular contributions;

(2) From conversion contributions, on a first-in-first-out basis; and

(3) From earnings.

(b) To the extent a distribution is treated as made from a particular conversion contribution, it is treated as made first from the portion, if any, that was includable in gross income as a result of the conversion.

Q–9. Are there special rules for determining the source of distributions under A–8 of this section?

A–9. Yes. For purposes of determining the source of distributions, the following rules apply:

(a) All distributions from an individual’s Roth IRAs made during a taxable year are aggregated.

(b) All regular contributions made for the same taxable year to all the individual’s Roth IRAs are aggregated and added to the undistributed total regular contributions for prior taxable years. Regular contributions for a taxable year include contributions made in the following taxable year that are identified as made for the taxable year in accordance with §1.408A–3 A–2. For example, a regular contribution made in 1999 for 1998 is aggregated with the contributions made in 1998 for 1998.

(c) All conversion contributions received during the same taxable year by all the individual’s Roth IRAs are aggregated. Notwithstanding the preceding sentence, all conversion contributions made by an individual during 1995 that were distributed from a traditional IRA in 1998 and with respect to which the 4-year spread contributions are treated for purposes of A–8(b) of this section as contributed to the individual’s Roth IRAs prior to any other conversion contributions made by the individual during 1999.

(d) A distribution from an individual’s Roth IRA that is rolled over to another Roth IRA of the individual in accordance with section 408A(e) is disregarded for purposes of determining the amount of both contributions and distributions.

(e) Any amount distributed as a corrective distribution (including net income, as described in A–1(d) of this section, is disregarded in determining the amount of contributions, earnings, and distributions.

(f) If an individual recharacterizes a regular or conversion contribution made to a Roth IRA (FIRST IRA) by transferring the contribution to a traditional IRA (SECOND IRA) in accordance with §1.408A–5, then pursuant to §1.408A–5 A–3, the contribution to the Roth IRA and the recharacterization transfer are disregarded in determining the amount of both contributions and distributions for the taxable year with respect to which the original contribution was made to the Roth IRA.

(g) Pursuant to §1.408A–5 A–3, the effect of income or loss (determined in accordance with §1.408A–5 A–2) occurring after the contribution to the FIRST IRA is disregarded in determining the amounts described in paragraphs (f) and (g) of this A–9. Thus, for purposes of paragraphs (f) and (g), the amount of the contribution is determined based on the original contribution.

Q–10. Are there examples to illustrate the ordering rules described in A–8 and A–9 of this section?

A–10. Yes. The following examples illustrate these ordering rules:

Example 1. In 1998, individual B converts $80,000 in his traditional IRA to a Roth IRA. B has a basis of $20,000 in the conversion amount and so must include the remaining $60,000 in gross income. He decides to spread the $60,000 income over $15,000 in each of the 4 years 1998–2001, under the rules of §1.408A–4 A–8. B also makes a regular contribution of $2,000 in 1998. If a distribution of $2,000 is made to B any time in 1998, it will be treated as made entirely from the regular contributions. so there will be no Federal income tax consequences as a result of the distribution.

Example 2. The facts are the same as in Example 1, except that the distribution made in 1998 is $5,000. The distribution is treated as made from $2,000 of regular contributions and $3,000 of conversion contributions that were includable in gross income. As a result, B must include $18,000 in gross income for 1998: 3,000 as a result of the acceleration of amounts that otherwise would have been included in later years under the 4-year spread rule and $15,000 includable under the regular 4-year spread rule. In addition, because the $3,000 is allocable to a conversion made within the previous 5
taxable years, the 10-percent additional tax under section 72) would apply to this $3,000 distribution for 1998, unless an exception applies. Under the 4-year-spread rule, B would now include in gross income $15,000 for 1999 and 2000, but only $12,000 for 2001, because of the accelerated inclusion of the $3,000 distribution.

Example 3. The facts are the same as in Example 1, except that B makes an additional $2,000 regular contribution in 1989 and he does not take a distribution in 1998. In 1999, the entire balance in the account, $90,000 ($84,000 of contributions and $6,000 of earnings), is distributed to B. The distribution is treated as made from $4,000 of regular contributions, $60,000 of conversion contributions that were includible in gross income, $20,000 of conversion contributions that were not includible in gross income, and $6,000 of earnings. Because a distribution has been made within the 4-year-spread period, B must account for the income inclusion under the 4-year-spread rule and must include in gross income the $45,000 remaining under the 4-year-spread rule in addition to the $90,000 of contributions. Because $90,000 of the distribution is allocable to a conversion made within the previous 5 taxable years, it is subject to the 10-percent additional tax under section 72 as if it were includible in gross income for 1999, unless an exception applies. The $6,000 allocable to earnings would be subject to the tax under section 72, unless an exception applies. Under the 4-year-spread rule, no amount would be includible in gross income in 2001 and, as a result, the entire amount of the conversion that was includible in gross income has already been included.

Example 4. The facts are the same as in Example 1, except that B also makes a $2,000 regular contribution in each year 1999 through 2002 and he does not take a distribution in 1998. A distribution of $85,000 is made to B in 2002. The distribution is treated as made from the $10,000 of regular contributions (the total regular contributions made in the years 1998, 1999, 2000, $2,000, and 2001) and the $60,000 of conversion contributions that were includible in gross income, and $15,000 of conversion contributions that were not includible in gross income. As a result, no amount of the distribution is includible in gross income; however, because the distribution is allocable to a conversion made within the previous 5 taxable years, the $60,000 is subject to the 10-percent additional tax under section 72 as if it were includible in gross income for 2002, unless an exception applies.

Example 5. The facts are the same as in Example 4, except no distribution occurs in 2002. In 2003, the entire balance in the account, $170,000 ($90,000 of contributions and $80,000 of earnings), is distributed to B. The distribution is treated as made from $10,000 of regular contributions, $60,000 of conversion contributions that were includible in gross income, $20,000 of conversion contributions that were not includible in gross income, and $80,000 of earnings. As a result, for 2003, B must include in gross income the $80,000 allocable to earnings, unless the distribution is a qualified distribution; and if it is not a qualified distribution, the $80,000 would be subject to the 10-percent additional tax under section 72, unless an exception applies.

Example 6. Individual C converts $20,000 to a Roth IRA in 1998 and $15,000 (in which amount C had a basis of $2,000) to another Roth IRA in 1999. No other contributions are made. In 2003, a $30,000 distribution, that is not a qualified distribution, is made to C. The distribution is treated as made from $20,000 of the 1998 conversion contribution and $10,000 of the 1999 conversion contribution that was includible in gross income. As a result, for 2003, no amount is includible in gross income; however, because $10,000 is allocable to a conversion contribution made within the previous 5 taxable years, that amount is subject to the 10-percent additional tax under section 72 as if it were allocable in gross income for 2003, unless an exception applies. The result would be the same whichever of C's Roth IRAs made the distribution.

Example 7. The facts are the same as in Example 6, except that the distribution is a qualified distribution. The result is the same as in Example 6, except that no amount would be subject to the 10-percent additional tax under section 72, because, to be a qualified distribution, the distribution must be made on or after the date on which the owner attains age 59½, made to a beneficiary or the estate of the owner on or after the date of the owner's death, or made to the owner's being within the meaning of section 72(m)(7), or to which section 72(2)(B) applies (distribution for a first-time home purchase). Under section 72(2)(E), each of these conditions is also an exception to the tax under section 72.

Example 8. Individual D makes a $2,000 regular contribution to a traditional IRA on January 1, 1999, for 1999. On April 15, 1999, when the $2,000 has increased to $2,500, D recharacterizes the contribution by transferring the $2,500 to a Roth IRA (pursuant to § 1.408A-5 A-1). In this case, D’s regular contribution to the Roth IRA for 1998 is $2,000. The $500 of earnings is not treated as a contribution to the Roth IRA. The results would be the same if the $2,000 had decreased to $1,500 prior to the recharacterization.

Example 9. In December 1998, individual E receives a distribution from his traditional IRA of $300,000 and in January 1999 he contributes the $300,000 to a Roth IRA as a conversion contribution. In April 1999, when the $300,000 has increased to $350,000, E recharacterizes the conversion contribution by transferring the $350,000 to a traditional IRA. In this case, E’s conversion contribution for 1998 is $300,000, because the $300,000 conversion contribution and the earnings of $50,000 are disregarded. The results would be the same if the $300,000 had decreased to $250,000 prior to the recharacterization. Further, since the conversion is disregarded, the $300,000 is not includible in gross income in 1998.

Q-11. If the owner of a Roth IRA dies prior to the end of the 5-taxable-year period described in A-1 of this section (relating to qualified distributions) or prior to the end of the 5-taxable-year period described in A-5 of this section (relating to conversions), how are different types of contributions in the Roth IRA allocated to multiple beneficiaries?

A-11. Each type of contribution is allocated to each beneficiary on a pro-rata basis. Thus, for example, if a Roth IRA owner dies in 1989, when the Roth IRA contains a regular contribution of $2,000, a conversion contribution of $6,000 and earnings of $1,000, and the owner leaves his Roth IRA equally to four children, each child will receive one quarter of each type of contribution. Pursuant to the ordering rules in A-8 of this section, an immediate distribution of $2,000 to one of the children will be deemed to consist of $500 of regular contributions and $1,500 of conversion contributions. A beneficiary's inherited Roth IRA may not be aggregated with any other Roth IRA maintained by such beneficiary (except for other Roth IRAs the beneficiary inherited from the same decedent), unless the beneficiary, as the result of the death, is the sole beneficiary of the Roth IRA, elects to treat the Roth IRA as his or her own (see A-7 and A-14 of this section).

Q-12. How do the withholding rules under section 3405 apply to Roth IRAs?

A-12. Distributions from a Roth IRA are distributions from an individual retirement plan for purposes of section 3405 and thus are designated distributions unless one of the exceptions in section 3405(e)(1) applies. Pursuant to section 3405(a) and (b), no distributions from a Roth IRA are subject to 10-percent withholding by the payor and periodic payments are subject to withholding as if the payments were wages. However, an individual can elect to have no withholding provided in accordance with section 3405(a)(1) and (b)(2).

Q-13. Do the withholding rules under section 3405 apply to conversions?

A-13. Yes. A conversion by any method described in § 1.408A-4 A-1 is considered a designated distribution subject to section 3405. However, a conversion occurring in 1998 by means of a trust-to-trustee transfer of an annuity from a traditional IRA to a Roth IRA established with the same or a different trustee is not required to be treated as a designated distribution for purposes of section 3405. Consequently, no withholding is required with respect to such a conversion (without regard to whether or not the individual elected to have no withholding).

Q-14. What minimum distribution rules apply to a Roth IRA?

A-14. (a) No minimum distributions are required to be made from a Roth IRA.
under section 408(a)(6) and (b)(3) (which generally incorporate the provisions of section 401(a)(9)) while the owner is alive. The post-death minimum distribution rules under section 401(a)(9)(B) that apply to traditional IRAs, with the exception of the at-least-as-rapidly rule described in section 401(a)(9)(B)(i), also apply to Roth IRAs.

(b) The minimum distribution rules apply to the Roth IRA as though the Roth IRA owner died before her or her required beginning date. Thus, generally, the entire interest in the Roth IRA must be distributed by the end of the fifth calendar year after the year of the owner's death unless the interest is payable to a designated beneficiary over a period not greater than that beneficiary's life expectancy and distributions before the end of the calendar year following the year of death. If the sole beneficiary is the decedent's spouse, such spouse may delay distributions until the transfer would have attained age 70½ or may treat the Roth IRA as his or her own.

c) Distributions to a beneficiary that are qualified distributions will be includible in the beneficiary's gross income according to the rules in A-4 of this section.

Q-15. Does section 401(a)(9) apply separately to Roth IRAs and individual retirement plans that are not Roth IRAs?

A-15. Yes. An individual required to receive minimum distributions from him or her own traditional or SIMPLE IRA cannot choose to take the amount of the minimum distributions from any Roth IRA. Similarly, an individual required to receive minimum distributions from a Roth IRA cannot choose to take the amount of the minimum distributions from one Roth IRA by distributing from another Roth IRA if the Roth IRAs were inherited from the same decedent.

Q-16. How is the basis of property distributed from a Roth IRA determined for purposes of a subsequent disposition?

A-16. The basis of property distributed from a Roth IRA is its fair market value (FMV) on the date of distribution, whether or not the distribution is a qualified distribution. Thus, for example, if a distribution consists of a share of stock in XYZ Corp. with an FMV of $40.00 on the date of distribution, for purposes of determining gain or loss on the subsequent sale of the share of XYZ Corp. stock, it has a basis of $40.00.

Q-17. What is the effect of distributing an amount from a Roth IRA and contributing it to another type of retirement plan other than a Roth IRA?

A-17. Any amount distributed from a Roth IRA and contributed to another type of retirement plan (other than a Roth IRA) is treated as a distribution from the Roth IRA that is neither a rollover contribution for purposes of section 408(d)(3) nor a qualified rollover contribution within the meaning of section 408(b) to another type of retirement plan. This treatment also applies to any amount transferred from a Roth IRA to any other type of retirement plan unless the transfer is a rollover contribution described in §1.408A-5.

Q-18. Can an amount be transferred directly from an education IRA to a Roth IRA (or distributed from an education IRA and rolled over to a Roth IRA)?

A-18. No amount may be transferred directly from an education IRA to a Roth IRA. A transfer of funds (or distribution and rollover) from an education IRA to a Roth IRA constitutes a distribution from the education IRA and a regular contribution to the Roth IRA (rather than a qualified rollover contribution to the Roth IRA).

Q-19. What are the Federal income tax consequences when a Roth IRA owner transferring his or her Roth IRA to another individual by gift?

A-19. A Roth IRA owner's transfer of his or her Roth IRA to another individual by gift constitutes an assignment of the owner's rights under the Roth IRA. At the time of the gift, the assets of the Roth IRA are deemed to be distributed to the owner and, accordingly, are treated as no longer held in a Roth IRA. In the case of any such gift of a Roth IRA made prior to October 1, 1998, if the entire interest in the Roth IRA is reconveyed to the Roth IRA owner prior to January 1, 1999, the Internal Revenue Service will treat the gift and reconveyance as never having occurred for estate tax, gift tax, and generation-skipping tax purposes and for purposes of this A-19.

§1.408A-7 Reporting.

This section sets forth the following questions and answers that relate to the reporting requirements applicable to Roth IRAs:

Q-1. What reporting requirements apply to Roth IRAs?

A-1. Generally, the reporting requirements applicable to IRAs other than Roth IRAs also apply to Roth IRAs, except that pursuant to section 408A(b)(3)(D), the trustee of a Roth IRA must include on Forms 1099-R and 5498 additional information as described in the instructions thereto. Any conversion of amounts from an IRA other than a Roth IRA to a Roth IRA is treated as a distribution for which a Form 1099-R must be filed by the trustee maintaining the non-Roth IRA. In addition, the owner of such IRAs must report the conversion by completing Form 8606. In the case of a recharacterization described in §1.408A-5 A-1, IRA owners must report such transactions in the manner prescribed in the instructions to the applicable Federal tax forms.

Q-2. Can a trustee rely on reasonable representations of a Roth IRA contributor or distributes for purposes of fulfilling reporting obligations?

A-2. A trustee maintaining a Roth IRA is permitted to rely on reasonable representations of a Roth IRA contributor or distributes for purposes of fulfilling reporting obligations.

§1.408A-8 Definitions.

This section sets forth the following question and answer that provides definitions of terms used in the provisions of §§1.408A-1 through 1.408A-7 and this section:

Q-1. Are there any special definitions that govern in applying the provisions of §§1.408A-1 through 1.408A-7 and this section?

A-1. Yes, the following definitions govern in applying the provisions of §§1.408A-1 through 1.408A-7 and this section. Unless the context indicates otherwise, the use of a particular term excludes the use of the other terms.

(a) Different types of IRAs—(1) IRA. Sections 408(a) and (b), respectively, describe an individual retirement account and an individual retirement annuity. The term IRA means an IRA described in either section 408(a) or (b), including each IRA described in paragraphs (a)(2) through (5) of this A-1. However, the term IRA does not include an education IRA described in section 530.

(2) Traditional IRA. The term traditional IRA means an individual retirement account or individual retirement annuity described in section 408(a) or (b), respectively. This term includes a SEP IRA but does not include a SIMPLE IRA or a Roth IRA.

(3) SEP IRA. Section 408(k) describes a simplified employee pension (SEP) as an employer-sponsored plan under which an employer can make contributions to IRAs established for its employees. The term SEP IRA means an IRA that receives contributions made under a SEP. The term SEP includes a salary reduction SEP (SARSEP) described in section 408(k)(6).
(4) SIMPLE IRA. Section 408(p) describes a SIMPLE IRA Plan as an employer-sponsored plan under which an employer can make contributions to SIMPLE IRAs established for its employees. The term SIMPLE IRA means an IRA to which the only contributions that can be made are contributions under a SIMPLE IRA Plan or rollovers or transfers from another SIMPLE IRA.

(5) Roth IRA. The term Roth IRA means an IRA that meets the requirements of section 408A.

(a) Other defined terms or phrases—

(1) 4-year spread. The term 4-year spread is described in §1.408A-4 A–8.

(2) Conversion. The term conversion means a transaction satisfying the requirements of §1.408A-4 A–1.

(3) Conversion amount or conversion contribution. The term conversion amount or conversion contribution is the amount of a distribution and contribution with respect to which a conversion described in §1.408A-4 A–1 is made.

(4) Failed conversion. The term failed conversion means a transaction in which an individual contributes to a Roth IRA an amount transferred or distributed from a traditional IRA or Simple IRA (including a transfer by redesignation) in a transaction that does not constitute a conversion under §1.408A-4 A–1.

(5) Modified AGI. The term modified AGI is defined in §1.408A–3 A–5.

(6) Recharacterization. The term recharacterization means a transaction described in §1.408A–5 A–1.

(7) Recharacterized amount or recharacterized contribution. The term recharacterized amount or recharacterized contribution means an amount or contribution treated as contributed to an IRA other than the one to which it was originally contributed pursuant to a recharacterization described in §1.408A–5 A–1.

(8) Taxable conversion amount. The term taxable conversion amount means the portion of a conversion amount includible in income on account of a conversion, determined under the rules of section 408(d)(1) and (2).

(9) Tax-free transfer. The term tax-free transfer means a tax-free rollover described in section 402(c), 402(e)(6), 403(a)(4), 403(a)(5), 403(b)(8), 403(b)(10) or 408(d)(3), or a tax-free trustee-to-trustee transfer.

(10) Treat an IRA as his or her own. The phrase treat an IRA as his or her own means to treat an IRA for which a surviving spouse is the sole beneficiary as his or her own IRA after the death of the IRA owner in accordance with the terms of the IRA instrument or in the manner provided in the regulations under section 408(a)(8) or (b)(3).

(11) Trustee. The term trustee includes a custodian or issuer (in the case of an annuity) of an IRA (except where the context clearly indicates otherwise).

§1.408A–9 Effective date.

This section contains the following question and answer providing the effective date of §§1.408A–1 through 1.408A–8:

Q. To what taxable years do §§1.408A–1 through 1.408A–8 apply?

A. Sections 1.408A–1 through 1.408A–8 apply to taxable years beginning on or after January 1, 1998.

PART 602—OMB CONTROL NUMBERS

UNDER THE PAPERWORK REDUCTION ACT

Paragraph 9. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805 • • •

Par. 10. In §602.101, paragraph (c) is amended by adding an entry in numerical order to the table to read as follows:

§602.101 OMB control numbers.

<table>
<thead>
<tr>
<th>CFR part or section where identified and described</th>
<th>Current OMB control No.</th>
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<tr>
<td>1.408A–2 ........................................... 1545–1616</td>
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<td>1.408A–4 ........................................... 1545–1616</td>
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<td>1.408A–5 ........................................... 1545–1616</td>
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<td>1.408A–7 ........................................... 1545–1616</td>
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Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Donald C. Lubick,
Assistant Secretary of the Treasury.

[FR Doc. 99-2550 Filed 2–3–99; 8:45 am]

BILLING CODE 4830-01-U
Appendix H:
Proposed regulations § 1.401(a)(9)

3928 Federal Register / Vol. 66, No. 11 / Wednesday, January 17, 2001 / Proposed Rules

foreign persons, then the payor or middleman must report the payment to the nonresident alien individual that is a resident of a country with which the United States has an income tax treaty or a tax information exchange agreement. If more than one of the joint account holders is a foreign person and is a resident of a country with which the United States has an income tax treaty or a tax information exchange agreement, then the payor or middleman may report the interest as paid to any such account holder that is treated as the primary account holder under §31.3406(b)-2(a) of this chapter. If, however, any account holder requests its own Form 1042–S, the payor or middleman must furnish a Form 1042–S to the account holder who requests it. (g) Effective date. Paragraph (h)(4) is effective for payee statements due after December 31 of the year in which the final regulations are published in the Federal Register, without regard to extensions. * * * *(For interest paid to a Canadian nonresident alien individual on or before December 31 of the year in which final regulations are published in the Federal Register, see §1.6049–6(e)(4) as in effect and contained in 26 CFR part 1 revised April 1, 2000.) * * * *

Par. 4. In section 1.6049–8, the section heading and paragraph (a) are revised to read as follows:

§1.6049–8 Interest and original issue discount paid to nonresident alien individuals.

(a) Interest subject to reporting requirement. For purposes of §§1.6049–4, 1.6049–6, and this section and except as provided in paragraph (b) of this section, the term interest means interest paid to a nonresident alien individual after December 31 of the year in which the final regulations are published in the Federal Register, where the interest is described in section 871(i)(2)(A) with respect to a deposit maintained at an office within the United States. For purposes of the regulations under section 6049, a nonresident alien individual is a person described in section 7701(b)(1)(B). The payor or middleman may rely upon a valid Form W–8 to determine whether the payment is made to a nonresident alien individual. Generally, amounts described in this paragraph (a) are not subject to backup withholding under section 3406. See §31.3406(g)(1)(d) of this chapter. However, if the payor or middleman does not have either a valid Form W–8 or valid Form W–9, the payor or middleman must report the payment as made to a U.S. non-exempt recipient if it must so treat the payee under the presumption rules of §§1.6049–5(d)(2) and 1.1441–1(b)(3)(ii) and must also backup withhold under section 3406. For interest paid to a Canadian nonresident alien individual on or before December 31 of the year in which final regulations are published in the Federal Register, see §1.6049–8(a) as in effect and contained in 26 CFR part 1 revised April 1, 2000.) * * * *

PART 31—EMPLOYMENT TAXES AND COLLECTION OF INCOME TAX AT SOURCE

Par. 5. The authority citation for part 31 continues to read in part as follows:

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

Par. 6. In §31.3406(g)-1, paragraph (d) is revised to read as follows:

§31.3406(g)-1 Exceptions for payments to certain payees and certain other payment. * * * *

(d) Reportable payments made to nonresident alien individuals. A payment of interest that is reported on Form 1042–S as paid to a nonresident alien individual under §1.6049–8(a) of this chapter is not subject to withholding under section 3406. For interest paid to a Canadian nonresident alien individual on or before December 31 of the year in which final regulations are published in the Federal Register, see §31.3406(g)(1)(d) as in effect and contained in 26 CFR part 1 revised April 1, 2000.)

Robert E. Wenzel, Deputy Commissioner of Internal Revenue.

BILLS & CODE 4035–4–U

DEPARTMENT OF TREASURY

Internal Revenue Service (IRS)

26 CFR Parts 1 and 54

[REG–130477–00; REG–130481–00]

RIN 1545–AY69, 1545–AY70

Required Distributions from Retirement Plans

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to required minimum distributions from qualified plans, individual retirement plans, deferred compensation plans under section 457, and section 403(b) annuity contracts, custodial accounts, and retirement income accounts. These regulations will provide the public with guidance necessary to comply with the law and will affect administrators of, participants in, and beneficiaries of qualified plans; institutions that sponsor and individuals who maintain individual retirement plans, individuals who use individual retirement plans for retirement income, and beneficiaries of individual retirement plans; and employees for whom amounts are contributed to section 403(b) annuity contracts, custodial accounts, or retirement income accounts and beneficiaries of such contracts and accounts.

DATES: Written and electronic comments must be received by April 17, 2001. Outlines of topics to be discussed at the public hearing scheduled for June 1, 2001, at 10 a.m. must be received by May 11, 2001.

ADDRESSES: Send submissions to: CC:IMSP:RU (REG–130477–00/ REG–130481–00) room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:IMSP:RU (REG–130477–00/ REG–130481–00), Courier’s Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the “Tax Regs” option of the IRS Home Page, or by submitting comments directly to the IRS Internet site at: http://www.irs.gov/tax_regs/reglist.html. The public hearing on June 1, 2001, will be held in the IRS Auditorium (7th Floor), Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Cathy A. Vols, 202–622–6099; concerning submissions and the hearing, and/or to be placed on the building access list to attend the hearing, Guy Traynor, 202– 622–7180 (not toll-free numbers).

Paperwork Reduction Act

The collections of information contained in these proposed regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–0996, in conjunction with the notice of proposed rulemaking published on July 27, 1987, 52 FR 28070, REG–ER–119–82, Required Distributions From Qualified Plans and Individual Retirement Plans, and control number 1545–1573, in
conjunction with the notice of proposed rulemaking published on December 30, 1997, 62 FR 67780, REG-209463-82. Required Distributions from Qualified Plans and Individual Retirement Plans.

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.

Books and records relating to the 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

This document contains proposed amendments to the Income Tax Regulations (26 CFR Part 1) and to the Pension Excise Tax Regulations (26 CFR Part 54) under sections 401, 403, 408, and 4974 of the Internal Revenue Code of 1986. It is contemplated that proposed rules similar to those in these proposed regulations applicable to section 401 will be published in the near future for purposes of applying the distribution requirements of section 457(d). These amendments are proposed to conform the regulations to section 1404 of the Small Business Job Protection Act of 1996 (SBPJFA) (110 Stat. 1791), sections 1211 and 1852 of the Tax Reform Act of 1986 (TRA of 1986) (100 Stat. 2464 and 2864), sections 521 and 713 of the Tax Reform Act of 1984 (TRA of 1984) (98 Stat. 865 and 885), and sections 242 and 243 of the Tax Equity and Fiscal Responsibility Act of 1992 (TEFRA) (96 Stat. 521). The regulations provide guidance on the required minimum distribution requirements under section 401(a)(9) for plans qualified under section 401(a).

The rules are incorporated by reference in section 408(a)(6) and (b)(3) for individual retirement accounts and annuities (IRAs), section 408A(c)(5) for Roth IRAs, section 403(b)(10) for section 403(b) annuity contracts, and section 457(d) for eligible deferred compensation plans.

For purposes of this discussion of the background of the regulations in this preamble, as well as the explanation of provisions below, whenever the term employee is used, it is intended to include not only an employee but also an IRA owner.

Section 401(a)(9) provides rules for distributions during the life of the employee in section 401(a)(9)(A) and rules for distributions after the death of the employee in section 401(a)(9)(B).

Section 401(a)(9)(A)(i) provides that the entire interest of an employee in a qualified plan must be distributed, beginning not later than the employee's required beginning date, in accordance with regulations, over the life of the employee or over the lives of the employee and a designated beneficiary (or over a period not extending beyond the life expectancy of the employee and a designated beneficiary).

Section 401(a)(9)(C) defines required beginning date for employees (other than 5-percent owners and IRA owners) as April 1 of the calendar year following the later of the calendar year in which the employee attains age 70 1/2 or the calendar year in which the employee retires. For 5-percent owners and IRA owners, the required beginning date is April 1 of the calendar year following the calendar year in which the employee attains age 70 1/2, even if the employee has not retired.

Section 401(a)(9)(D) provides that (except in the case of a life annuity) the life expectancy of an employee and the employee's spouse that is used to determine the period over which payments must be made may be redetermined, but not more frequently than annually.

Section 401(a)(9)(E) provides that the term designated beneficiary means any individual designated as a beneficiary by the employee.

Section 401(a)(9)(G) provides that any distribution required to satisfy the incidental death benefit requirement of section 401(a) is a required minimum distribution.

Section 401(a)(9)(B)(i) provides that, if the employee dies after distributions have begun, the employee's interest must be distributed at least as rapidly as under the method used by the employee.

Section 401(a)(9)(B)(ii) and (iii) provides that, if the employee dies before required minimum distributions have begun, the employee's interest must be either: distributed (in accordance with regulations) over the life or life expectancy of the designated beneficiary with the distributions beginning no later than 1 year after the date of the employee's death, or distributed within 5 years after the death of the employee. However, under section 401(a)(9)(B)(iv), a surviving spouse may wait until the date the employee would have attained age 70 1/2 to begin taking required minimum distributions.

Comprehensive proposed regulations under section 401(a)(9) were previously published in the Federal Register on July 27, 1987, 52 FR 28070. Many of the comments on the 1987 proposed regulations expressed concerns that the required minimum distribution must be satisfied separately for each IRA owned by an individual by taking distributions from each IRA. In response, Notice 88-38 (1988-1 C.B. 524) provided that the amount of the required minimum distribution must be calculated for each IRA, but permitted that amount to be taken from any IRA. Amendments to the 1987 proposed regulations published in the Federal Register, December 30, 1997, 62 FR 67780, responded to comments on the use of trusts as beneficiaries. Notice 96-67 (1996-2 C.B. 235) and Notice 97-75 (1997-2 C.B. 377) contain further changes to section 401(a)(9) by the SBPJFA. The guidance in Notice 88-38, Notice 96-67, and Notice 97-75 is incorporated in these proposed regulations with some modifications.

Even though the distribution requirements added by TEFRA were retroactively repealed by TPA of 1984, the transition election rule in section 242(b) of TEFRA was preserved. Notice 83-23 (1983-2 C.B. 418) continues to provide guidance for distributions permitted by this transition election rule. These proposed regulations retain the additional guidance on the transition rule provided in the 1987 proposed regulations.

As discussed below, in response to extensive comments, the rules for calculating required minimum distributions from individual accounts under the 1987 proposed regulations have been substantially simplified.

Certain other 1987 rules have also been simplified and modified, although many of the 1987 rules remain unchanged. In particular, due to the relatively small number of comments on practices with respect to annuity contracts, and the effect of the 1987 proposed regulations on these practices, the basic structure of the 1987 proposed regulation provisions with respect to annuity payments is retained in these proposed regulations. The IRS and Treasury are continuing to study these rules and specifically request updated comments on current practices and issues relating to required minimum distributions from annuity contracts.

Explanation of Provisions

Overview

Many of the comments on the 1987 proposed regulations addressed the rules for required minimum distributions during an employee's life, including calculation of life expectancy and determination of the designated beneficiary. In particular, comments raised concerns about the default
provisions, election requirements, and plan language requirements. In general, the new life expectancy decisions at age 70½, which under the 1987 proposed regulations would bind the employee in future years during which financial circumstances could change significantly, was perceived as unreasonably restrictive. In addition, the determination of life expectancy and designated beneficiary and the resulting required minimum distribution calculation for individual accounts were viewed as too complex.

To respond to these concerns, these proposed regulations would make it much easier for individuals—both plan participants and IRA owners—and plan administrators to understand and apply the minimum distribution rules. The new proposed regulations would make major simplifications to the rules, including the calculation of the required minimum distribution during the individual’s lifetime and the determination of a designated beneficiary for distributions after death.

The new proposed regulations simplify the rules by:

- Providing a simple, uniform table that all employees can use to determine the minimum distribution required during their lifetime. This makes it easier to calculate the required minimum distribution because employees would no longer need to determine their beneficiary by the required beginning date, would no longer need to decide whether or not to recalculate their life expectancy each year in determining required minimum distributions, and would no longer need to satisfy a separate incidental death benefit rule.
- Permitting the required minimum distribution during the employee’s lifetime to be calculated without regard to the beneficiary’s age (except when required distributions can be reduced by taking into account the age of a beneficiary who is a spouse more than 10 years younger than the employee).
- Permitting the beneficiary to be determined as late as the end of the year following the year of the employee’s death. This allows the employee to change designated beneficiaries after the required beginning date without increasing the required minimum distribution and permits the beneficiary to be changed after the employee’s death, such as by one or more beneficiaries disclaiming or being cashed out.
- Permitting the calculation of post-death minimum distributions to take into account an employee’s remaining life expectancy at the time of death, thus allowing distributions in all cases to be spread over a number of years after death. These simplifications would also have the effect of reducing the required minimum distributions for the vast majority of employees.

The Uniform Distribution Period

Under these proposed regulations and the 1987 proposed regulations, for distributions from an individual account, the required minimum distribution is determined by dividing the account balance by the distribution period. For lifetime required minimum distributions, these proposed regulations simplify the uniform distribution period for all employees of the same age. The uniform distribution period table is the required minimum distribution incidental benefit (MDIB) divisor table originally prescribed in § 1.401(a)(9)-2 of the 1987 proposed regulations and now included in A-4 of § 1.401(a)-5 of the new proposed regulations. An exception applies if the employee’s sole beneficiary is the employee’s spouse and the spouse is more than 10 years younger than the employee. In that case, the employee is permitted to use the longer distribution period measured by the joint life and last survivor life expectancy of the employee and spouse.

These changes provide a simple administrable required for plans and individuals. Using the MDIB table, most employees will be able to determine their required minimum distribution for each year based on nothing more than their current age and their account balance as of the end of the prior year (which IRA trustees report annually to IRA owners). Under the 1987 proposed regulations, some employees already use the MDIB table to determine required minimum distributions. Under the new proposed regulations, they would continue to do so. For the majority of other employees, required minimum distributions would be reduced as a result of the changes.

For years after the year of the employee’s death, the distribution period is generally the remaining life expectancy of the designated beneficiary. The beneficiary’s remaining life expectancy is calculated using the age of the beneficiary in the year following the year of the employee’s death, reduced by one for each subsequent year. If the employee’s spouse is the employee’s sole beneficiary at the end of the year following the year of death, the distribution period during the spouse’s life is the spouse’s single life expectancy. For years after the year of the spouse’s death, the distribution period is the spouse’s life expectancy calculated in the year of death, reduced by one for each subsequent year. If the beneficiary is a designated beneficiary as of the end of the year after the employee’s death, the distribution period is the employee’s life expectancy calculated the year of death, reduced by one for each subsequent year.

The MDIB table is based on joint life expectancies of an individual and survivor 10 years younger at each age beginning at age 70. Allowing the use of this table reflects the fact that an employee’s beneficiary is subject to change until the death of the employee and ultimately may be a beneficiary more than 10 years younger than the employee. The proposed regulations would allow lifetime distributions at a rate consistent with this possibility. Consistent with the requirements of section 401(a)(9)(A)(ii), the distributive period after death is measured by the life expectancy of the employee’s designated beneficiary in the year following death, or the employee’s remaining life expectancy if there is no designated beneficiary. This ensures that the employee’s entire benefit is distributed over a period described in section 401(a)(9)(A)(ii), i.e., the life expectancy of the employee or the joint life expectancy of the employee and a designated beneficiary.

The approach in these proposed regulations allowing the use of a uniform lifetime distribution period addresses concerns raised in comments on the 1987 proposed regulations that the rules are too complex. It eliminates the use of two tables and the interactions of the multiple beneficiary and change in beneficiary rules. Finally, it eliminates the need to fix the amount the distribution during the employee’s lifetime based on the beneficiary designated on the required beginning date and eliminates the need to elect recalculation or no recalculation of life expectancies at the required beginning date.

Suggestions have been received that the life expectancy table used to calculate required minimum distributions should be revised to reflect recent increases in longevity. These proposed regulations instead provide authority for the Commissioner to issues guidance of general applicability revising the life expectancy tables and the uniform distribution table in the future if it becomes appropriate. While life expectancy has increased in the 1 years since the issuance of the section 72 life expectancy tables, those tables may already overstate the average life expectancy of the class of individuals who are subject to these required
minimum distribution rules (qualified plan participants, IRA owners, et al.). That is because those existing section 72 tables were derived, from the particular mortality experience of the select population of individuals who purchase individual annuities, as opposed to the population who are subject to the required minimum distribution rules. In any event, as noted earlier, the new proposed uniform distribution period—equal to the joint life expectancy of an individual and a survivor 10 years younger at each age—would lengthen the lifetime distribution period for most employees and beneficiaries. In fact, the new proposed regulations would lengthen that period more for many individuals than would an update to reflect recent increases in longevity. The IRS and Treasury believe that this lengthening of the distribution period for most employees provides further justification for retaining the existing life expectancy tables at this time.

Some commentators suggested that the calculation of required minimum distributions include credit for any distribution in a prior year that exceeded that year's required minimum distribution. However, such a "credit" carryforward would require significant additional data retention and would add substantial complexity to the calculation of required minimum distributions. By using the prior year's ending account balance for calculating required minimum distributions, distribution of amounts in excess of the required minimum distribution has the effect of reducing future required minimum distributions over the remaining distribution period to some extent. Accordingly, these proposed regulations do not provide for a credit carryforward.

**Determination of the Designated Beneficiary**

These proposed regulations provide that, generally, the designated beneficiary is determined as of the end of the year following the year of the employee's death rather than as of the employee's required beginning date or date of death, as under the 1987 proposed regulations. Thus, any beneficiary eliminated by distribution of the benefit or through disclaimer (or otherwise) during the period between the employee's death and the end of the year following the year of death is disregarded in determining the employee's designated beneficiary for purposes of calculating required minimum distributions. If, as of the end of the year following the year of the employee's death, the employee has more than one designated beneficiary and the account or benefit has not been divided into separate accounts or shares for each beneficiary, the beneficiary with the shortest life expectancy is the designated beneficiary, consistent with the approach in the 1987 proposed regulations.

This approach for determining the designated beneficiary following the death of an employee after the employee's required beginning date is simpler in several respects than the approach in the 1987 proposed regulations and responds to concerns raised with respect to the effects of beneficiary designation at the required beginning date. Under this approach, the determination of the designated beneficiary and the calculation of the beneficiary's life expectancy generally are contemporaneous with commencement of required distributions to the beneficiary. Any prior beneficiary designation is irrelevant for distributions from individual accounts, unless the employee takes advantage of a lifetime distribution period measured by the joint life expectancy of the employee and a spouse more than 10 years younger than the employee. Further, for an employee with a designated beneficiary, this approach provides the same rules for distributions after the employee's death, regardless of whether death occurs before or after an employee's required beginning date.

Finally, in the case of an employee who elects or defaults into recalculation of life expectancy and who dies without a designated beneficiary, the requirement that the employee's entire remaining account balance be distributed in the year after an employee's death has been eliminated and replaced with a distribution period equal to the employee's remaining life expectancy recalculated immediately before death.

**Default Rule for Post-Death Distributions**

As requested by some commentators, these proposed regulations would change the default rule in the case of death before the employee's required beginning date for a nonspouse designated beneficiary from the 5-year rule in section 401(a)(9)(B)(i) to the life expectancy rule in section 401(a)(9)(B)(ii). Thus, absent a plan provision or election of the 5-year rule, the life expectancy rule would apply in all cases in which the employee has a designated beneficiary. As in the case of death on or after the employee's required beginning date, the designated beneficiary whose life expectancy is used to determine the distribution period would be determined as of the end of the year following the year of the employee's death, rather than as of the employee's date of death (as would have been required under the 1987 proposed regulations). The 5-year rule would apply automatically only if the employee did not have a designated beneficiary as of the end of the year following the year of the employee's death. Finally, in the case of death before the employee's required beginning date, these proposed regulations allow a waiver, unless the Commissioner determines otherwise, of any excise tax resulting from the life expectancy rule during the first five years after the year of the employee's death if the employee's entire benefit is distributed by the end of the fifth year following the year of the employee's death.

**Annuity Payments**

These proposed regulations make several changes to the rules for determining whether annuity payments satisfy section 401(a)(9). The changes are designed to make these rules more administrable without adverse effects on the basic structure and application of the rules. The IRS and Treasury are continuing to study and evaluate whether additional changes would be appropriate for determining whether annuity payments satisfy section 401(a)(9). Some comments were received on the annuity rules in 1987, but updated comments that include a discussion of current industry practices, products, and concerns would be helpful.

These proposed regulations provide that the designated beneficiary for determining the distribution period for annuity payments generally is the beneficiary as of the annuity starting date, even if that date is after the required beginning date. Thus, if annuity payments commence after the required beginning date, the determination of the designated beneficiary is contemporaneous with the annuity starting date and any intervening changes in the beneficiary designation since the required beginning date are ignored. Second, as requested in comments, these regulations extend to all annuity payment streams the rule in the 1987 proposed regulations that allows a life annuity with a period certain not exceeding 20 years to commence on the required beginning date with no makeup for the first distribution calendar year. For this purpose, the regulations clarify that only accruals as of the end of the prior calendar year must be taken into account in calculating the amount of an annuity.
commencing on the required beginning date. Subsequent accruals are treated as additional accruals that must be taken into account in the next calendar year. Also as requested in comments, the regulations provide that, although additional accruals need to be taken into account in the first payment in the calendar year following the year of the accrual, actual payment in the form of a make-up payment need only be completed by the end of that calendar year.

The permitted increase in annuity payments to an employee upon the death of the survivor beneficiary is to be expanded to cover the elimination of the survivor portion of a joint and survivor annuity due to a qualified domestic relations order. Further, in response to comments, in the case of an annuity contract purchased from an insurance company, an exception to the nonincreasing-payment requirement in these proposed regulations has been added to accommodate a cash refund upon the employee's death of the amount of the premiums paid for the contract.

One of the rules in the 1987 proposed regulations that the IRS and Treasury are continuing to study and evaluate is the rule providing that if the distributions from a defined benefit plan are not in the form of an annuity, the employee's benefit will be treated as an individual account for purposes of determining required minimum distributions. The IRS and Treasury are continuing to consider whether the rule permitting the benefit under a defined benefit plan to be divided into segregated shares for purposes of section 401(a)(9) is useful and appropriate for defined benefit plans.

Trust as Beneficiary

These proposed regulations retain the provision in the proposed regulations, as amended in 1997, allowing an underlying beneficiary of a trust to be an employee's designated beneficiary for purposes of determining required minimum distributions when the trust is named as the beneficiary of a retirement plan or IRA, provided that certain requirements are met. One of these requirements is that documentation of the underlying beneficiaries of the trust be provided timely to the plan administrator. In the case of individual accounts, unless the lifetime distribution period for an employee is measured by the joint life expectancy of the employee and the employee's spouse, the deadline under these proposed regulations for providing the beneficiary documentation would be the end of the year following year of the employee's death. This is consistent with the deadline for determining the employee's designated beneficiary. Because the designated beneficiary during an employee's lifetime is not relevant for determining lifetime required minimum distributions in most cases under these proposed regulations, the burden of lifetime documentation requirements contained in the previous proposed regulations is significantly reduced.

A significant number of commentators on the 1997 amendment to the proposed regulations requested clarification that a testamentary trust named as an employee's beneficiary is a trust that qualifies for the look-through rule to the underlying beneficiaries, as permitted in the 1997 proposed regulations. These proposed regulations provide examples in which a testamentary trust is named as an employee's beneficiary and the look-through trust rules apply. As previously illustrated in the facts of Rev. Rul. 2006–2, 2006–3 I.R.B. 305, the examples also clarify that remainders of a 'QTP' trust must be taken into account as beneficiaries in determining the distribution period for required minimum distributions if amounts are allocated to their benefit during the life of the income beneficiary under the trust.

Rules for Qualified Domestic Relations Orders

These proposed regulations retain the basic rules in the 1987 proposed regulation for a qualified domestic relations order (QDRO). Thus, for example, the proposed regulations continue to provide that a former spouse to whom all or a portion of the employee's benefit is payable pursuant to a QDRO will be treated as a spouse (including a surviving spouse) of the employee for purposes of section 401(a)(9), including the minimum distribution incidental benefit requirement, regardless of whether the QDRO specifically provides that the former spouse is treated as the spouse for purposes of sections 401(a)(11) and 417. This rule applies regardless of the number of former spouses an employee has who are alternate payees with respect to the employee's retirement benefits. Further, for example, if a QDRO divides the individual account of an employee in a defined contribution plan into a separate account for the employee and a separate account for the alternate payee, the required minimum distribution to the alternate payee during the lifetime of the employee must nevertheless be determined using the same rules that apply to distribution to the employee. Thus, required minimum distributions to the alternate payee must commence by the employee's required beginning date. However, the required minimum distribution for the alternate payee will be separately determined. The required minimum distributions for the alternate payee would be determined either using the uniform distribution period discussed above based on the age of the employee in the distribution calendar year, or, if the alternate payee is the employee's former spouse and is more than 10 years younger than the employee, using the joint life expectancy of the employee and the alternate payee.

Election of Surviving Spouse To Treat An Inherited IRA As Spouse's Own IRA

These proposed regulations clarify this rule in the 1987 proposed regulations that allow the surviving spouse of a deceased IRA owner to elect to treat an IRA inherited by the surviving spouse from that owner as that owner's own IRA. The 1987 proposed regulations provide that this election is deemed to have been made if the surviving spouse contributes to the IRA or does not take the required minimum distribution for the year under section 401(a)(9)(B) as a beneficiary of the IRA. These new proposed regulations clarify that this deemed election is permitted to be made only after the distribution of the required minimum amount for the account, if any, for the year of the individual's death. Further these new proposed regulations clarify that this deemed election is permitted only if the spouse is the sole beneficiary of the account and has an unlimited right to withdrawal from the account. This requirement is not satisfied if a trust is named as beneficiary of the IRA, even if the spouse is the sole beneficiary of the trust. These clarifications make the election consistent with the underlying premise that the surviving spouse could have received a distribution of the entire deceased IRA owner's account and rolled it over to an IRA established in the surviving spouse's own name as IR owner.

These new proposed regulations also clarify that, except for the required minimum distribution for the year of the individual's death, the spouse is permitted to roll over the post-death required minimum distribution under section 401(a)(9)(B) for a year if the spouse is establishing the IRA rollover account in the name of the spouse as
IRA owner. However, if the surviving spouse is age 70½ or older, the minimum lifetime distribution required under section 401(a)(9)(A) must be made for the year and, because it is a required minimum distribution, that amount may not be rolled over. These proposed regulations provide that this election by a surviving spouse eligible to treat an IRA as the spouse's own may also be accomplished by redesignating the IRA with the name of the surviving spouse as owner rather than beneficiary.

IRA Reporting of Required Minimum Distributions

Because these regulations substantially simplify the calculation of required minimum distributions from IRAs, IRA trustees determining the account balance as of the end of the year can also calculate the following year's required minimum distribution for each IRA. To improve compliance and further reduce the burden imposed on IRA owners and beneficiaries, under the authority provided in section 408(l), these proposed regulations would require the trustee of each IRA to report the amount of the required minimum distribution from the IRA to the IRA owner or beneficiary and to the IRS at the time and in the manner provided under IRS forms and instructions. This reporting would be required regardless of whether the IRA owner is planning to take the required minimum distribution from that IRA or from another IRA, and would indicate that the IRA owner is permitted to take the required minimum contribution from any other IRA of the owner. During year 2001, the IRS will be receiving public comments and consulting with interested parties to assist the IRS in evaluating what form best accommodates this reporting requirement, what timing is appropriate (e.g., the beginning of the calendar year for which the required amount is being calculated), and what effective date would be most appropriate for the reporting requirement. In this context, after thorough consideration of comments and consultation with interested parties, the IRS intends to develop procedures and a schedule for reporting that provides adequate lead time, and minimizes the reporting burden, for IRA trustees, issuers, and custodians in complying with this new reporting requirement while providing the most useful information to the IRA owners and beneficiaries.

The IRS and Treasury are also considering whether similar reporting would be appropriate for section 403(b) contracts.

Permitted Delays Relative to QDROs and State Insurer Delinquency Proceedings

The regulations permit the required minimum distribution for a year to be delayed to a later year in certain circumstances. Specifically, commentators requested a delay during a period of up to 18 months during which an amount is segregated in connection with the review of a domestic relations order pursuant to section 414(p)(7). Commentators also requested that a delay be permitted while annuity payments under an annuity contract issued by a life insurance company in state insurer delinquency proceedings have been reduced or suspended by reason of state proceedings. These proposed regulations allow delay in these circumstances.

Correction of Failures Under Section 401(a)(9)

The proposed regulations do not set forth the special rule relieving a plan from disqualification for isolated instances of failure to satisfy section 401(a)(9) because all failures for qualified plans and section 403(b) accounts under section 401(a)(9) are now permitted to be corrected through the Employee Plans Compliance Resolution System (EPCRS). See Rev. Proc. 2000–16 (2000–6 I.R.B. 518).

Amendment of Qualified Plans

These regulations are proposed to be effective for distributions for calendar years beginning on or after January 1, 2002. For distributions for calendar years beginning before the effective date of final regulations, plan sponsors can continue to rely on the 1987 proposed regulations, to the extent those proposed regulations are not inconsistent with the changes to section 401(a)(9) made by the Small Business Job Protection Act of 1996 (SBPJA) and guidance related to those changes. Alternatively, for distributions for the 2001 and subsequent calendar years beginning before the effective date of final regulations, plan sponsors are permitted, but not required, to follow these proposed regulations in the operation of their plans by adopting the model amendment set forth below.

The Treasury Department and the IRS are making the model amendment set forth below available to plan sponsors to permit them to apply these proposed regulations in the operation of their plans without violating the requirement that a plan be operated in accordance with its terms. Plan sponsors who adopt the model amendment will have reliance that, during the term of the amendment, operation of their plans in a manner that satisfies the minimum distribution requirements in these proposed regulations will not cause their plans to fail to be qualified. In addition, distributors will have reliance that distributions that are made during the term of the amendment that satisfy the minimum distribution requirements in these proposed regulations. The model amendment may be adopted by plan sponsors, practitioners who sponsor volume submitter specimen plans and plans of master and prototype (M&P) plans.

These proposed regulations permit plans to make distributions under either default provisions or under permissible optional provisions. A plan that has been amended by adoption of the model amendment will be treated as operating in conformance with a requirement of the proposed regulations that permits the use of either default or optional provisions if the plan is operated consistently in accordance with either the default rule or a specific permitted alternative, notwithstanding the plan’s terms.

The Service will not issue determination, opinion or advisory letters on the basis of the changes in these proposed regulations until the publication of final regulations. Until such time, the IRS may continue to issue such letters on the basis of the 1987 proposed regulations and SBPJA. Although the IRS will not issue determination, opinion or advisory letters with respect to the model amendment, the adoption of the model amendment will not affect a determination letter issued for a plan whose terms otherwise satisfy the 1987 proposed regulations and SBPJA. Plan sponsors should not adopt other amendments to attempt to conform their plans to the changes in these proposed regulations before the publication of final regulations. The IRS intends to publish procedures at a later date that will allow qualified plans to be amended to reflect the regulations under section 401(a)(9) when they are finalized.

Qualified plans are required to be amended for changes in the plan qualification requirements made by GUST by the end of the GUST remedial amendment period under section 401(b), which is generally the end of the first plan year beginning on or after January 1, 2001, or, if applicable, a later date determined under the provisions of section 19 of Rev. Proc. 2000–20 (2000–6 I.R.B. 553). Many plans have been operated in a manner that reflects the changes to section 401(a)(9) made by SBPJA and will have to be amended for...
these changes by the end of the GUST remedial amendment period. The IRS intends that its procedures for amending qualified plans for the final regulations under section 401(a)(9) will generally avoid the need for plan sponsors, volume submitter practitioners and M&P plan sponsors to request another determination, opinion or advisory letter subsequent to their application for a GUST letter. In addition, to the extent such a subsequent letter is needed or desired, the IRS intends that its procedures will provide that the application for the letter will not have to be submitted prior to the next time the plan is otherwise amended or required to be amended.

The model amendment described above is set forth below:

With respect to distributions under the Plan made in calendar years beginning on or after January 1, 2000 (ALTERNATIVELY, SPECIFY A LATER CALENDAR YEAR FOR WHICH THE AMENDMENT IS TO BE INITIALLY EFFECTIVE), the Plan will apply the minimum distribution requirements of section 401(a)(9) of the Internal Revenue Code in accordance with the regulations under section 401(a)(9) that were proposed in January 2001, notwithstanding any provision of the Plan to the contrary. This amendment shall continue in effect until the end of the last calendar year beginning before the effective date of final regulations under section 401(a)(9) or such other date specified in guidance published by the Internal Revenue Service.

Amendment of IRAs and Effective Date

These regulations are proposed to be effective for distributions for calendar years beginning on or after January 1, 2002. For distributions for the 2001 calendar year, IRA owners are permitted, but not required, to follow these proposed regulations in operation, notwithstanding the terms of the IRA documents. IRA owners may therefore rely on these proposed regulations for distributions for the 2001 calendar year. However, IRA sponsors should not amend their IRA documents to conform their IRAs to the changes in these proposed regulations before the publication of final regulations. The IRS will not issue model IRAs on the basis of the changes in these proposed regulations until the publication of final regulations. Until such time, IRA owners can continue to use the current model IRAs which are based on the 1987 proposed regulations under section 401(a)(9). The IRS will publish procedures at a later date that will allow IRAs to be amended to reflect final regulations under section 401(a)(9).
§ 1.401(a)(9) is also issued under 26 U.S.C. 408(a)(6) and (b)(3). * * *

Par. 2. Sections 401(a)(9) through 1.401(a)(9)-8 are added to read as follows:

§ 1.401(a)(9)-0 Required minimum distributions; table of contents.

This table of contents lists the regulations relating to required minimum distributions under section 401(a)(9) of the Internal Revenue Code as follows:

§ 1.401(a)(9)-0 Required minimum distributions; table of contents.

§ 1.401(a)(9)-1 Required minimum distribution requirement in general. 

§ 1.401(a)(9)-2 Determination of the designated beneficiary.

§ 1.401(a)(9)-3 Determination of the required minimum distribution.

§ 1.401(a)(9)-4 Determination of the required distribution from defined contribution plans.

§ 1.401(a)(9)-5 Determination of the required minimum distribution from defined benefit plans.

§ 1.401(a)(9)-6 Required minimum distributions from defined benefit plans.

§ 1.401(a)(9)-7 Rollovers and transfers.

§ 1.401(a)(9)-8 Special rules.

§ 1.401(a)(9)-1 Required minimum distribution requirement in general.

Q-1. What plans are subject to the required minimum distribution requirement under section 401(a)(9) and §§ 1.401(a)(9)-1 through 1.401(a)(9)-8?

A-1. All stock bonus, pension, and profit-sharing plans qualified under section 401(a) and annuity contracts described in section 403(a) are subject to the required minimum distribution rules of section 401(a) and §§ 1.401(a)(9)-1 through 1.401(a)(9)-8. See § 1.403(b)-2 for the distribution rules applicable to annuity contracts or custodial accounts described in section 403(b), see § 1.401-8 for the distribution rules applicable to individual retirement plans, see § 1.408A-6 described for the distribution rules applicable to Roth IRAs under section 408A, and see section 457(d)(2)(A) for distribution rules applicable to certain deferred compensation plans for employees of tax-exempt organizations or state and local government employees.

Q-2. Which employee account balances and benefits held under qualified trusts and plans are subject to the distribution rules of section 401(a)(9) and §§ 1.401(a)(9)-1 through 1.401(a)(9)-8?

A-2. The distribution rules of section 401(a)(9) apply to all account balances and benefits in existence on or after January 1, 1985. Sections 1.401(a)(9)-1 through 1.401(a)(9)-8 apply for purposes of determining required minimum distributions for calendar years beginning on or after January 1, 2002.

Q-3. What specific provisions must a plan contain in order to satisfy section 401(a)(9)?

A-3. (a) Required provisions. In order to satisfy section 401(a)(9), the plan must include several written provisions reflecting section 401(a)(9). First, the plan must generally set forth the statutory rules of section 401(a)(9), including the incidental death benefit requirement in section 401(a)(9)(G). Second, the plan must provide that distributions will be made in accordance with §§ 1.401(a)(9)-1 through 1.401(a)(9)-8. The plan document must also provide that the provisions reflecting section 401(a)(9) override any distribution options in the plan inconsistent with section 401(a)(9). The plan also must include any other provisions reflecting section 401(a)(9) as are prescribed by the Commissioner in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin. See § 601.601[d](2)(ii)(b) of this chapter.

(b) Optional provisions. The plan may also include written provisions regarding any optional provisions governing plan distributions that do not conflict with section 401(a)(9) and the regulations thereunder.

(c) Absence of optional provisions. Plan distributions commencing after an employee’s death will be required to be made under the default provisions set forth in § 1.401(a)(9)-3 for distributions unless the plan document contains optional provisions that override such default provisions. Thus, if distributions have not commenced to the employee at the time of the employee’s death, distributions after the death of an employee are to be made automatically in accordance with the default provisions in A-4(a) of § 1.401(a)(9)-3 unless the plan either specifies in accordance with A-4(b) of § 1.401(a)(9)-3 the method under which distributions will be made or provides for elections by the employee (or beneficiary) in accordance with A-4(c) of § 1.401(a)(9)-3 and such elections are made by the employee or beneficiary.

§ 1.401(a)(9)-2 Distributions commencing before an employee’s death.

Q-1. In the case of distributions commencing before an employee’s death, how must the employee’s entire interest be distributed in order to satisfy section 401(a)(9)?

A-1. (a) In order to satisfy section 401(a)(9)(A), the entire interest of each employee must be distributed to such employee not later than the required beginning date, or must be distributed, beginning not later than the required beginning date, over the life of the employee or joint lives of the employee and a designated beneficiary or over a period not extending beyond the life expectancy of the employee or the joint life and last survivor expectancy of the employee and the designated beneficiary.

(b) Section 401(a)(9)(G) provides that lifetime distributions must satisfy the incidental death benefit requirements.

(c) The amount required to be distributed for each calendar year in order to satisfy section 401(a)(9)(A) and (G) generally depends on whether a distribution is in the form of distributions under a defined contribution plan or annuity payments under a defined benefit plan. For the method of determining the required minimum distribution in accordance with section 401(a)(9)(A) and (G) from an individual account under a defined contribution plan, see § 1.401(a)(9)-5. For the method of determining the required minimum distribution in accordance with section 401(a)(9)(A) and (G) in the case of annuity payments from a defined benefit plan or an annuity contract, see § 1.401(a)(9)-6.

Q-2. For purposes of section 401(a)(9)(C), what does the term required beginning date mean?

A-2. (a) Except as provided in paragraph (b) of this A-2 with respect to a 5-percent owner, as defined in paragraph (c), the term required beginning date means April 1 of the calendar year following the later of the calendar year in which the employee attains age 70½, or the calendar year in which the employee retires from employment with the employer maintaining the plan.

(b) In the case of an employee who is a 5-percent owner, the term required beginning date means April 1 of the calendar year following the calendar year in which the employee attains age 70½.

(c) For purposes of section 401(a)(9), a 5-percent owner is an employee who is a 5-percent owner (as defined in section 410) with respect to the plan year ending in the calendar year in which the employee attains age 70½.

(d) Paragraph (b) of this A-2 does not apply in the case of a governmental plan (within the meaning of section 414(d)) or a church plan. For purposes of this paragraph, the term church plan means a plan maintained by a church for church employees, and the term church means any church (as defined in section 3121(w)(3)(A)) or qualified church-controlled organization (as defined in section 3121(w)(3)(B)).
(e) A plan is permitted to provide that the required beginning date for purposes of section 401(a)(9) for all employees is April 1 of the calendar year following the calendar year in which the employee attains age 70⅓ regardless of whether the employee is a 5-percent owner.

Q-3. When does an employee attain age 70⅓?

A-3. An employee attains age 70⅓ as of the date six calendar months after the 70th anniversary of the employee’s birth. For example, if an employee’s date of birth was June 30, 1932, the 70th anniversary of such employee’s birth is June 30, 2002. Such employee attains age 70⅓ on December 30, 2002. Consequently, if the employee is a 5-percent owner or retired, such employee’s required beginning date is April 1, 2003. However, if the employee’s date of birth was July 1, 1932, the 70th anniversary of such employee’s birth would be July 1, 2002. Such employee would then attain age 70⅓ on January 1, 2003 and such employee’s required beginning date would be April 1, 2004.

Q-4. Must distributions made before the employee’s required beginning date satisfy section 401(a)(9)?

A-4. Lifetime distributions made before the employee’s required beginning date for calendar years before the employee’s first distribution calendar year, as defined in A-1(b) of § 1.401(a)(9)-5, need not be made in accordance with section 401(a)(9). However, if distributions commence before the employee’s required beginning date under a particular distribution option, such as in the form of an annuity, the distribution option fails to satisfy section 401(a)(9) at the time distributions commence if, under terms of the particular distribution option, distributions to be made for the employee’s first distribution calendar year or any subsequent distribution calendar year will fail to satisfy section 401(a)(9).

Q-5. If distributions have begun to an employee before the employee’s death (in accordance with section 401(a)(9)(A)(ii)), how must distributions be made after an employee’s death?

A-5. Section 401(a)(9)(B)(i) provides that if the distribution of the employee’s interest has begun in accordance with section 401(a)(9)(A)(ii) and the employee dies before his entire interest has been distributed to him, the remaining portion of such interest must be distributed at least as rapidly as under the distribution method being used under section 401(a)(9)(A)(ii) as of the date of his death. The amount required to be distributed for each distribution calendar year following the calendar year of death generally depends on whether a distribution is in the form of distributions from an individual account under a defined contribution plan or annuity payments under a defined benefit plan. For the method of determining the required minimum distribution in accordance with section 401(a)(9)(B)(i) from an individual account, see A-5(a) of § 1.401(a)(9)-5 for the calculation of the distribution period that applies when an employee dies after the employee’s required beginning date. In the case of annuity payments from a defined benefit plan or an annuity contract, see § 1.401(a)(9)-6.

Q-6. For purposes of section 401(a)(9)(B), when are distributions considered to have begun to the employee in accordance with section 401(a)(9)(A)(iii)?

A-6. (a) General rule. Except as otherwise provided in A-10 of § 1.401(a)(9)-6, distributions are not treated as having begun to the employee in accordance with section 401(a)(9)(A)(iii) until the employee’s required beginning date, without regard to whether payments have been made before that date. For example, if employee A upon retirement in 2002, the calendar year A attains age 65½ begins receiving installment distributions from a profit-sharing plan over a period not exceeding the joint life and last survivor expectancy of A and A’s beneficiary, benefits are not treated as having begun in accordance with section 401(a)(9)(A)(iii) until April 1, 2008 (the April 1 following the calendar year in which A attains age 70⅓). Consequently, if such employee dies before April 1, 2008 (A’s required beginning date), distributions after A’s death must be made in accordance with section 401(a)(9)(B)(ii) or (iii) and (iv) and § 1.401(a)(9)-4, and not section 401(a)(9)(B)(i). This is the case without regard to whether the plan has distributed the minimum distribution for the first distribution calendar year (as defined in A-1(b) of § 1.401(a)(9)-5) before A’s death.

(b) A plan provides, in accordance with A-2(e) of this section, that the required beginning date for purposes of section 401(a)(9) for all employees is April 1 of the calendar year following the calendar year in which the employee attains age 70⅓, an employee who dies after the required beginning date determined under the plan terms is treated as dying after the employee’s required beginning date for purposes of A-5(a) of this section even though the employee dies before the April 1 following the calendar year in which the employee retires. § 1.401(a)(9)-3 Death before required beginning date.

Q-1. If an employee dies before the employee’s required beginning date, how must the employee’s entire interest be distributed in order to satisfy section 401(a)(9)?

A-1. (a) Except as otherwise provided in A-10 of § 1.401(a)(9)-6, if an employee dies before the employee’s required beginning date (and, thus, generally before distributions are treated as having begun in accordance with section 401(a)(9)), the employee’s entire interest must be made in accordance with one of the methods described in section 401(a)(9)(B)(ii) or (iii). One method (the five-year rule in section 401(a)(9)(B)(ii)) requires that the entire interest of the employee be distributed within five years of the employee’s death regardless of who or what entity receives the distributions. Another method (the life expectancy rule in section 401(a)(9)(B)(iii)) requires that any portion of an employee’s interest payable to (or for the benefit of) a designated beneficiary be distributed, commencing within one year of the employee’s death, over the life of such beneficiary (or over a period not extending beyond the life expectancy of such beneficiary). Section 401(a)(9)(B)(iv) provides special rules where the designated beneficiary is the surviving spouse of the employee, including a special commuted benefit date for distributions under section 401(a)(9)(B)(iii) to the surviving spouse.

(b) See A-4 of this section for the rules for determining which of the methods described in paragraph (a) applies. See A-3 of this section to determine when distributions under the exception to the five-year rule in section 401(a)(9)(B)(iii) and (iv) must commence. See A-2 of this section to determine when the five-year period in section 401(a)(9)(B)(iii) ends. For distributions using the life expectancy rule in section 401(a)(9)(B)(iii) and (iv), see § 1.401(a)(9)-4 in order to determine the designated beneficiary under section 401(a)(9)(B)(iii) and (iv), see § 1.401(a)(9)-6 for required minimum distributions under defined benefit plans.

Q-2. By when must the employee’s entire interest be distributed in order to satisfy the five-year rule in section 401(a)(9)(B)(ii)?
A-2. In order to satisfy the five-year rule in section 401(a)(9)(B)(ii), the employee's entire interest must be distributed by the end of the calendar year which contains the fifth anniversary of the date of the employee's death. For example, if an employee dies on January 1, 2002, the entire interest must be distributed by the end of 2007, in order to satisfy the five-year rule in section 401(a)(9)(B)(ii).

Q-3. When are distributions required to commence in order to satisfy the life expectancy rule in section 401(a)(9)(B)(ii) or (iv)?

A-3. (a) Nonspouse beneficiary. In order to satisfy the life expectancy rule in section 401(a)(9)(B)(ii), if the designated beneficiary is not the employee's surviving spouse, distributions must commence on or before the end of the calendar year immediately following the calendar year in which the employee died. This rule also applies to the distribution of the entire remaining benefit if another individual is a designated beneficiary in addition to the employee's surviving spouse. See A-2 and A-3 of § 1.401(a)(9)-8, however, if the employee's benefit is divided into separate accounts (or segregated shares, in the case of a defined benefit plan).

(b) Spousal beneficiary. In order to satisfy the rule in section 401(a)(9)(B)(ii) and (iv), if the sole designated beneficiary is the employee's surviving spouse, distributions must commence on or before the later of—

(1) The end of the calendar year immediately following the calendar year in which the employee died; and

(2) The end of the calendar year in which the employee would have attained age 70½.

Q-4. How is it determined whether the five-year rule in section 401(a)(9)(B)(ii) or the life expectancy rule in section 401(a)(9)(B)(iii) and (iv) applies to a distribution?

A-4. (a) No plan provision. If a plan does not adopt an optional provision described in paragraph (b) or (c) of this section, the method of distribution of the death of an employee, distribution must be made as follows:

(1) If the employee has a designated beneficiary, as determined under § 1.401(a)(9)-4, distributions are to be made in accordance with the life expectancy rule in section 401(a)(9)(B)(ii) and (iv).

(2) If the employee has no designated beneficiary, distributions are to be made in accordance with the five-year rule in section 401(a)(9)(B)(ii).

(b) Optional plan provisions. The plan may adopt a provision specifying either

that the five-year rule in section 401(a)(9)(B)(ii) will apply to certain distributions after the death of an employee even if the employee has a designated beneficiary or that distribution in every case will be made in accordance with the five-year rule in section 401(a)(9)(B)(ii). Further, a plan need not have the same method of distribution for the benefits of all employees.

(c) Elections. A plan may adopt a provision that permits employees (or beneficiaries) to elect on an individual basis whether the five-year rule in section 401(a)(9)(B)(ii) or the life expectancy rule in section 401(a)(9)(B)(iii) and (iv) applies to distributions after the death of an employee who has a designated beneficiary. Such an election must be made no later than the earlier of, the end of the calendar year in which distribution would be required to commence in order to satisfy the requirements for the life expectancy rule in section 401(a)(9)(B)(ii) and (iv) (see A-3 of this section for the determination of such calendar year), or the end of the calendar year which contains the fifth anniversary of the date of death of the employee. As of the date determined under the life expectancy rule, the election must be irrevocable with respect to the beneficiary (and all subsequent beneficiaries) and must apply to all subsequent calendar years. If a plan provides for the election, the plan may also specify the method of distribution that applies if neither the employee nor the beneficiary makes the election. If neither the employee nor the beneficiary elects a method and the plan does not specify which method applies, distribution must be made in accordance with the election made by the employee.

Q-5. If the employee's surviving spouse is the employee's designated beneficiary and such spouse dies after the employee, but before distributions have begun to the surviving spouse under section 401(a)(9)(B)(ii) and (iv), how is the employee's interest to be distributed?

A-5. Pursuant to section 401(a)(9)(B)(iv)(II), if the surviving spouse dies after the employee, but before distributions to such spouse have begun under section 401(a)(9)(B)(ii) and (iv), the five-year rule in section 401(a)(9)(B)(ii) and the life expectancy rule in section 401(a)(9)(B)(iii) are to be applied as if the surviving spouse were the employee. In applying this rule, the date of death of the surviving spouse shall be substituted for the date of death of the employee. However, in such case, the rules of section 401(a)(9)(B)(iv) are not available to the surviving spouse of the deceased employee's surviving spouse.

Q-6. For purposes of section 401(a)(9)(B)(iv)(III), when are distributions considered to have begun to the surviving spouse of an employee, for purposes of section 401(a)(9)(B)(iv)(II), on the date determined in accordance with A-3 of this section, on which distributions are required to commence to the surviving spouse, even though payments have actually been made before that date. See A-11 of § 1.401(a)(9)-6 for a special rule for annuities.

§ 1.401(a)(9)-4 Determination of the designated beneficiary.

Q-1. Who is a designated beneficiary under section 401(a)(9)?

A-1. A designated beneficiary is an individual who is designated as a beneficiary under the plan. An individual may be designated as a beneficiary under the plan either by the terms of the plan or, if the plan so provides, by an affirmative election by the employee (or the employee’s surviving spouse) specifying the beneficiary. A beneficiary designated as such under the plan is an individual who is entitled to a portion of an employee's benefit, contingent on the employee's death or another specified event. For example, if a distribution is in the form of a joint and survivor annuity over the life of the employee and another individual, the plan does not satisfy section 401(a)(9) unless such other individual is a designated beneficiary under the plan. A designated beneficiary need not be specified by name in the plan or by the employee to the plan in order to be a designated beneficiary so long as the individual who is to be the beneficiary is identifiable under the plan as of the date the beneficiary is determined under A-4 of this section. The members of a class of beneficiaries capable of expansion or contraction will be treated as being identifiable if it is possible, as of the date the beneficiary is determined, to identify the class members with the shortest life expectancy. The fact that an employee's designated beneficiary is a certain individual under applicable state law does not make that individual a designated beneficiary unless the individual is designated as a beneficiary under the plan.

Q-2. Must an employee (or the employee's spouse) make an affirmative election specifying a beneficiary for a distribution to be a designated beneficiary under section 401(a)(9)(E)?
A-2. No. A designated beneficiary is an individual who is designated as a beneficiary under the plan whether or not the designation under the plan was made by the employee. The choice of beneficiary is subject to the requirements of sections 401(a)(11), 414(p), and 417.

Q-3. May a person other than an individual be considered to be a designated beneficiary for purposes of section 401(a)(9)?

A-3. (a) No. Only individuals may be designated beneficiaries for purposes of section 401(a)(9). A person that is not an individual, such as the employee’s estate, may not be a designated beneficiary, and, if a person other than an individual is designated as a beneficiary of an employee’s benefit, the employee will be treated as having no designated beneficiary for purposes of section 401(a)(9). However, see A-5 of this section for special rules which apply to trusts.

(b) If an employee is treated as having no designated beneficiary, for distributions under a defined contribution plan, the distribution period under section 401(a)(9)(A)(ii) after the death of the employee is limited to the period described in A-5(a)(2) of § 1.401(a)(9)-5 (the remaining life expectancy of the employee determined in accordance with A-5(c)(3) of § 1.401(a)(9)-5). Further, in such case, except as provided in A-10 of § 1.401(a)(9)-6, if the employee dies before the employee’s required beginning date, distribution must be made in accordance with the 5-year rule in section 401(a)(9)(B)(ii).

Q-4. When is the designated beneficiary determined?

A-4. (a) General rule. Except as provided in paragraph (b) and § 1.401(a)(9)-6, the employee’s designated beneficiary will be determined based on the beneficiaries designated as of the last day of the calendar year following the calendar year of the employee’s death. Consequently, except as provided in § 1.401(a)(9)-6, any person who was a beneficiary as of the date of the employee’s death, but is not a beneficiary as of that later date (e.g., because the person disclaims entitlement to the benefit in favor of another beneficiary or because the person receives the entire benefit to which the person is entitled before that date), is not taken into account in determining the employee’s designated beneficiary for purposes of determining the distribution period for required minimum distributions after the employee’s death.

(b) Surviving spouse. As provided in A-5 of § 1.401(a)(9)-3, in the case in which the employee’s spouse is the designated beneficiary as of the date described in paragraph (a) of this A-5, and the surviving spouse dies after the employee and before the date on which distributions have begun to the spouse under section 401(a)(9)(B)(iii) and (iv), the rule in section 401(a)(9)(B)(iv)(III) will apply. Thus, the relevant designated beneficiary for determining the distribution period is the designated beneficiary elected as having spouse. Such designated beneficiary will be determined as of the last day of the calendar year following the calendar year of surviving spouse’s death. If, as of such date, no designated beneficiary is designated with respect to that surviving spouse, distribution must be made in accordance with the 5-year rule in section 401(a)(9)(B)(ii) and A-2 of § 1.401(a)(9)-5 will apply. Thus, the relevant designated beneficiary for determining the distribution period is the designated beneficiary elected as having spouse.

(c) Multiple beneficiaries.

Notwithstanding anything in this A-4 to the contrary, the rules in A-7 of § 1.401(a)(9)-5 apply if more than one beneficiary is designated with respect to an employee as of the date on which the designated beneficiary is to be determined in accordance with paragraphs (a) and (b) of this A-4.

Q-5. If a trust is named as a beneficiary of an employee, will the beneficiaries of the trust have the same rights as a designated beneficiary?

A-5. Only one individual may be a designated beneficiary for purposes of determining the distribution period under section 401(a)(9). Consequently, a trust is not a designated beneficiary even though the trust is named as a beneficiary. However, if the requirements of Paragraph (b) of this A-5 are met, the beneficiaries of the trust will be treated as having been designated as beneficiaries of the employee under the plan for purposes of determining the distribution period under section 401(a)(9).

(b) The requirements of this paragraph (b) are met if, during any period during which required minimum distributions are being determined by treating the beneficiaries of the trust as designated beneficiaries of the employee, the following requirements are met:

(1) The trust is a valid trust under state law, or would be but for the fact that there is no corpus.

(2) The trust is irrevocable or will, by its terms, become irrevocable upon the death of the employee.

(3) The beneficiaries of the trust who are beneficiaries with respect to the trust’s interest in the employee’s benefit are identifiable from the trust instrument in the meaning of A-1 of this section.

Q-6. The documentation described in A-4 of this section has been provided to the plan administrator. In what form must the documentation be provided to the plan administrator?

A-6. (a) Required minimum distributions before death. In order to satisfy the documentation requirement of this A-6 for required minimum distributions under section 401(a)(9) to commence before the death of an employee, the employee must comply with either paragraph (a)(1) or (2) of this A-6:

(1) The employee provides to the plan administrator a copy of the trust instrument and a statement that the trust instrument is amended at any time in the future, the employee will, within a reasonable time, provide to the plan administrator a copy of such amendment.

(2) The employee—

(i) Provides to the plan administrator a list of all of the beneficiaries of the trust (including contingent and intr懿ary) and a copy of the trust instrument and a statement that the trust instrument is amended at any time in the future, the employee will, within a reasonable time, provide to the plan administrator a copy of such amendment; and

(ii) Certifies that, to the best of the employee’s knowledge, this list is correct and complete and that the trust instrument and a copy of the trust instrument is amended at any time in the future, the employee will, within a reasonable time, provide to the plan administrator a copy of such amendment; and

(iii) Agrees that, if the trust instrument is amended at any time in the future, the employee will, within a reasonable time, provide to the plan administrator, after a reasonable time, a copy of the amended trust instrument or an amendment to the trust instrument that is corrected as of the date the amendment changes any information previously presented;
(iv) Agrees to provide a copy of the trust instrument to the plan administrator upon demand.

(b) Required minimum distributions after death. In order to satisfy the documentation requirement of this A–6 for required minimum distributions after the death of the employee, by the last day of the calendar year immediately following the calendar year in which the employee died, the trustee of the trust must either—

1. Provide the plan administrator with a final list of all beneficiaries of the trust (including contingent and remaindermen beneficiaries with a description of the conditions on their entitlement) as of the end of the calendar year following the calendar year of the employee’s death; certify that, to the best of the trustee’s knowledge, this list is correct and complete and that the requirements of paragraph (b)(1), (2), and (3) of A–5 of this section are satisfied; and agree to provide a copy of the trust instrument to the plan administrator upon demand; or

2. Provide the plan administrator with a copy of the actual trust document for the trust that is named as a beneficiary of the employee under the plan as of the employee’s date of death.

(c) Relief for discrepancy between trust instrument and employee certifications or earlier trust instruments. (1) If required minimum distributions are determined based on the information provided to the plan administrator in certifications or trust instruments described in paragraph (a)(1), (a)(2) or (b) of this A–6, a plan will not fail to satisfy section 401(a)(9) merely because the actual terms of the trust instrument are inconsistent with the information in those certifications or trust instruments previously provided to the plan administrator, but only if the plan administrator reasonably relied on the information provided and the required minimum distributions for calendar years after the calendar year in which the discrepancy is discovered are determined based on the actual terms of the trust instrument.

(2) For purposes of determining the amount of the excise tax under section 4974, the required minimum distribution is determined for any year based on the actual terms of the trust in effect during the year.

§1.401(a)(9)–5 Required minimum distributions from defined contribution plans.

Q–1. If an employee’s benefit is in the form of an individual account under a defined contribution plan, what is the amount required to be distributed for each calendar year?

A–1. (a) General rule. If an employee’s accrued benefit is in the form of an individual account under a defined contribution plan, the minimum amount required to be distributed for each distribution calendar year, as defined in paragraph (b) of this A–1, is equal to the quotient obtained by dividing the account (determined under A–3 of this section) by the applicable distribution period (determined under A–4 of this section). However, the required minimum distribution amount will never exceed the entire vested account balance on the date of the distribution.

Further, the minimum distribution required to be distributed on or before an employee’s required beginning date is always determined under section 401(a)(9)(A)(ii) and this A–1 and not section 401(a)(9)(A)(i).

(b) Distribution calendar year. A calendar year for which a minimum distribution is required is a distribution calendar year. If an employee’s required beginning date is April 1 of the calendar year following the calendar year in which the employee attains age 70 1/2, the employee’s first distribution calendar year is the year the employee attains age 70 1/2. If an employee’s required beginning date is April 1 of the calendar year in which the employee retires, the calendar year in which the employee retires is the employee’s first distribution calendar year. In the case of distributions to be made in accordance with the life expectancy rule in §1.401(a)(9)–3 and in section 401(a)(9)(B)(iii) and (iv), the first distribution calendar year is the calendar year containing the date described in A–3(1) of A–3 of this A–1.

(c) Time for distributions. The distribution required to be made on or before the employee’s required beginning date shall be treated as the distribution required for the employee’s first distribution calendar year (as defined in paragraph (b) of this A–1). The required minimum distribution for other distribution calendar years, including the required minimum distribution for the distribution calendar year in which the employee’s required beginning date occurs, must be made on or before the end of that distribution calendar year.

(d) Minimum distribution incidental benefit requirement. If distributions are made in accordance with this section, the minimum distribution incidental benefit requirement of section 401(a)(9)(C) will be satisfied.

(a) Annuity contracts. Instead of satisfying this A–1, the required minimum distribution requirement may be satisfied by the purchase of an annuity contract from an insurance company in accordance with A–4 of §1.401(a)(9)–6 with the employee’s entire individual account. If such an annuity is purchased after distributions are required to commence (the required beginning date, in the case of distributions commencing before death, or the date determined under A–3 of §1.401(a)(9)–6 in the case of distributions commencing after death), payments under the annuity contract purchased will satisfy section 401(a)(9) for distribution purposes of determining if the individual account satisfies section 401(a)(9) for the calendar year of the purchase. An employee may purchase an annuity contract for a portion of the employee’s account under the rules of A–2(c) of §1.401(a)(9)–8.

Q–2. If an employee’s benefit is in the form of an individual account and, in any calendar year, the amount distributed exceeds the minimum required, will credit be given in subsequent calendar years for such excess distribution?

A–2. If, for any distribution calendar year, the amount distributed exceeds the minimum required, no credit will be given in subsequent calendar years for such excess distribution.

Q–3. What is the amount of the account of an employee used for determining the employee’s required minimum distribution in the case of an individual account?

A–3. (a) In the case of an individual account, the benefit used in determining the required minimum distribution for a distribution calendar year is the account balance as of the last valuation date in the calendar year immediately preceding that distribution calendar year (valuation calendar year) adjusted in accordance with paragraphs (b) and (c) of this A–3.

(b) The account balance is increased by the amount of any contributions or forfeitures allocated to the account balance as of dates in the valuation calendar year after the valuation date. Contributions include contributions made after the close of the valuation calendar year which are allocated as of dates in the valuation calendar year.

(c)(1) The account balance is decreased by distributions made in the
value calendar year after the
valuation date.

(2)(i) The following rule applies if any portion of the required minimum distribution for the first distribution calendar year is made in the second distribution calendar year (i.e., generally, the distribution calendar year in which the required beginning date occurs). In such case, for purposes of determining the account balance to be used for determining the required minimum distribution for the second distribution calendar year, distributions described in paragraph (c)(1) shall include an additional amount. This additional amount is equal to the amount of any distribution made in the second distribution calendar year on or before the required beginning date that is made in that year (when added to the amounts distributed in the first calendar year) of the amount required to meet the required minimum distribution for the first distribution calendar year.

(ii) This paragraph (c)(2)(i) is illustrated by the following example:

Example. (i) Employee X, born October 1, 1931, is an unmarried participant in a qualified deferred compensation plan (Plan 2). After retirement, X attains age 70½ in calendar year 2002. X's required beginning date is April 1, 2003. As of the last valuation date under Plan Z in calendar year 2001, which was on December 31, 2001, the value of X's account balance was $25,400. No contributions are made or amounts forfeited after such date which are allocated in the calendar year 2001. No rollover amounts are received after such date by Plan Z on X's behalf which were distributed by a qualified plan or IRA in calendar years 2001, 2002, or 2003. The applicable distribution period from the table in A-4(a)(4) for an individual age 71 is 25.3 years. The required minimum distribution for calendar year 2002 is $1,000 ($25,400 divided by 25.3). That amount is distributed to X on April 1, 2003.

(ii) The value of X's account balance as of December 31, 2002 (the last valuation date under Plan Z in calendar year 2002) is $26,400. No contributions are made or amounts forfeited after such date which are allocated in calendar year 2002. In order to determine the benefit to be used in calculating the required minimum distribution for calendar year 2003, the account balance of $26,400 will be reduced by $1,000, the amount of the required minimum distribution for calendar year 2002 made on April 1, 2003. Consequently, the benefit for purposes of determining the required minimum distribution for calendar year 2003 is $25,400. If, instead of $1,000 being distributed to X, $20,000 is distributed on April 1, 2003, the account balance of $26,400 would still be reduced by $1,000 in order to determine the benefit to be used in calculating the required minimum distribution for calendar year 2003. The amount of the distribution made on April 1, 2003, in order to meet the required minimum distribution for 2002 would still be $1,000. The remaining $19,000 ($20,000 - $1,000) of the distribution is not the required minimum distribution for 2002. Instead, the remaining $19,000 of the distribution is sufficient to satisfy the required minimum distribution requirement with respect to X for calendar year 2003. Consequently, no additional amount is required to be distributed to X in 2003 because $19,000 exceeds $1,040.10.

However, pursuant to A-2 of this section, the remaining $17,959.90 ($19,000 - $1,040.10) may not be used to satisfy the required minimum distribution requirements for calendar year 2004 or any subsequent calendar years.

(d) If an amount is distributed by one plan and rolled over to another plan (receiving plan), A-2 of §1.401(a)(9)-7 provides additional rules for determining the benefit and required minimum distribution under the receiving plan. If an amount is transferred from one plan (transferor plan) to another plan (transferee plan), A-3 and A-4 of §1.401(a)(9)-7 provide additional rules for determining the amount of the required minimum distribution which is required to be distributed under both the transferor and transferee plans.

Q-4. For required minimum distributions during an employee's lifetime, what is one applicable distribution period?

A-4. (a) General rule—(1) Applicable distribution period. Except as provided in paragraph (b) of this A-4, the applicable distribution period for required minimum distributions for distribution calendar years up to and including the distribution calendar year that includes the employee's date of death is determined using the table in paragraph (a)(2) for the employee's age as of the employee's birthday in the relevant distribution calendar year.

(2) Table for determining distribution period—(i) General rule. The following table is used for determining the distribution period for lifetime distributions to an employee.

<table>
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<th>Age of the employee</th>
<th>Distribution period</th>
</tr>
</thead>
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<td>81</td>
<td>16.0</td>
</tr>
<tr>
<td>82</td>
<td>15.3</td>
</tr>
</tbody>
</table>

(ii) Authority for revised table. The table in A-4(a)(2)(i) of this section may be replaced by any revised table prescribed by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin. See §601.601(d)(2)(ii)(b) of this chapter.

(b) Spouse is sole beneficiary. If the sole designated beneficiary of an employee is the employee's surviving spouse, for required minimum distributions during the employee's lifetime, the applicable distribution period is the longer of the distribution period determined in accordance with paragraph (a) of this A-4 or the joint life expectancy of the employee and spouse using the employee's and spouse's attained ages as of the employee's and the spouse's birthdays in the distribution calendar year. The spouse is sole designated beneficiary for purposes of determining the applicable distribution period for a distribution calendar year during the employee's lifetime if the spouse is the sole beneficiary of the employee's entire interest at all times during the distribution calendar year.

Q-5. For required minimum distributions after an employee's death, what is the applicable distribution period?

A-5. (a) Death on or after the employee's required beginning date. If an employee dies on or after
distribution has begun as determined under A–6 of § 1.401(a)(9)–2 (generally after the employee's required beginning date), in order to satisfy section 401(a)(9)(D)(i), the applicable distribution period for distribution calendar years after the distribution calendar year containing the employee’s date of death is either—

1. the employee’s specified beneficiary as of the date determined under A–4 of § 1.401(a)(9)–4, the remaining life expectancy of the employee’s designated beneficiary determined in accordance with paragraph(c)(1) or (2) of A–5; or

2. if the employee does not have a designated beneficiary as of the date determined under A–4(a) of § 1.401(a)(9)–4, the remaining life expectancy of the employee determined in accordance with paragraph(c)(3) of this A–5.

(b) Death before an employee’s required beginning date. If an employee dies before distribution has begun as determined under A–5 of § 1.401(a)(9)–2 (generally before the employee’s required beginning date), in order to satisfy section 401(a)(9)(B)(iii) or (iv) and the life expectancy rule described in A–1 of § 1.401(a)(9)–3, the applicable distribution period for distribution calendar years after the distribution calendar year containing the employee’s date of death is the remaining life expectancy of the employee’s designated beneficiary, determined in accordance with paragraph(c)(1) or (2) of this A–5.

(c) Life expectancy—(1) Nonspouse designated beneficiary. The applicable distribution period measured by the beneficiary’s remaining life expectancy is determined using the beneficiary’s age as of the beneficiary’s birthday in the calendar year immediately following the calendar year of the employee’s death. In subsequent calendar years the applicable distribution period is reduced by one for each calendar year that has elapsed since the calendar year of the employee’s death.

(2) Spouse designated beneficiary. If the surviving spouse of the employee is the employee’s sole beneficiary, the applicable period is measured by the surviving spouse’s life expectancy using the surviving spouse’s birthday for each distribution calendar year for which a required minimum distribution is required after the calendar year of the death. For calendar years after the calendar year of the spouse’s death, the spouse’s remaining life expectancy is the life expectancy of the spouse using the age of the spouse as of the spouse’s birthday in the calendar year of the spouse’s death. In subsequent calendar years, the applicable distribution period is reduced by one for each calendar year that has elapsed since the calendar year immediately following the calendar year of the spouse’s death.

(3) No designated beneficiary. The applicable distribution period measured by the employee’s remaining life expectancy is the life expectancy of the employee using the age of the employee as of the employee’s birthday in the calendar year of the employee’s death. In subsequent calendar years the applicable distribution period is reduced by one for each calendar year that has elapsed since the calendar year of the employee’s death.

Q–6. What life expectancy must be used for purposes of determining required minimum distributions under section 401(a)(9)?

A–6. (a) General rule. Unless otherwise prescribed in accordance with paragraph(b) of this A–6, life expectancies for purposes of determining required minimum distributions under section 401(a)(9) must be computed using of the expected return multipies in Tables V and VI of § 1.72–9.

(b) Revised expected return table. The expected return multiples described in paragraph(a) of this A–6 may be replaced by revised expected return multiples prescribed for use for purposes of determining required minimum distributions under section 401(a)(9) by the Commissioner in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin. See § 601.601(d)(2)(iii)(ii) of this chapter.

Q–7. If an employee has more than one designated beneficiary, which designated beneficiary’s life expectancy will be used to determine the applicable distribution period?

A–7. (a) General rule. (1) Except as otherwise provided in paragraph(c) of this A–7, if more than one individual is designated as a beneficiary with respect to an employee as of any applicable date for determining the designated beneficiary, the designated beneficiary with the shortest life expectancy will be the designated beneficiary for purposes of determining the distribution period. However, except as otherwise provided in A–5 of § 1.401(a)(9)–4 and paragraph (c)(1) of this A–7, if a person other than an individual is designated as a beneficiary, the employee will be treated as not having any designated beneficiaries for purposes of section 401(a)(9) even if there are also individuals designated as beneficiaries.

(2) See A–2 of § 1.401(a)(9)–8 for special rules which apply if an employee’s benefit under a plan is divided into separate accounts (or segregated shares in the case of a defined benefit plan) and the beneficiaries with respect to a separate account differ from the beneficiaries of another separate account.

(b) Contingent beneficiary. Except as provided in paragraph(c)(1) of this A–7, if a beneficiary’s entitlement to an employee’s benefit is contingent on an event other than the employee’s death or the death of another beneficiary, such contingent beneficiary is considered to be a designated beneficiary for purposes of determining which designated beneficiary has the shortest life expectancy under paragraph(a) of this A–7.

(c) Death contingency. (1) If a beneficiary (subsequent beneficiary) is entitled to any portion of an employee’s benefit only if another beneficiary dies before the entire benefit to which that other beneficiary is entitled has been distributed by the plan, the subsequent beneficiary will not be considered a beneficiary for purposes of determining who is the designated beneficiary with the shortest life expectancy under paragraph(a) of this A–7 or whether a beneficiary who is not an individual is a beneficiary. This rule does not apply if the other beneficiary dies prior to the applicable date for determining the designated beneficiary.

(2) If the designated beneficiary whose life expectancy is being used to calculate the distribution period dies on or after the applicable date, such beneficiary’s remaining life expectancy will be used to determine the distribution period whether or not a beneficiary with a shorter life expectancy receives the benefit.

(3) This paragraph (c) is illustrated by the following examples:

Example 1. Employer E maintains a defined contribution plan. Plan Unmarried Employee E dies in calendar year 2001 at age 30. As of December 31, 2002, D, the sister of C, is the beneficiary of C’s account balance under Plan W. Prior to death C has designated that, if D dies before C’s entire account balance has been distributed to D, E, mother of C and D, will be the beneficiary of the account balance. Because E is only entitled, as a beneficiary, to any portion of C’s account if D dies before the entire account has been distributed, E is disregarded in determining C’s designated beneficiary. Accordingly, even after D’s death, D’s life expectancy continues to be used to determine the distribution period.

Example 2. (1) Employee M maintains a defined contribution plan, Plan X. Employee X leaves a defined contribution plan, Plan X. Employee X, an employee of M, died in 2001 at the age of 50 years old. Prior to A’s death, M had
established an account balance for A in Plan X. A's account balance is invested only in productive assets. A named the trustee of a testamentary trust (Trust P) established under A's will as the beneficiary of all amounts payable from A's account in Plan X after A's death. A copy of the Trust P and a list of the trust beneficiaries were provided to the plan administrator of Plan X by the end of the calendar year following the calendar year of A's death. As of the date of A's death, the Trust P was irrevocable and was a valid trust under the laws of the state of A's domicile. A's account balance in Plan X was includable in A's gross estate under §2036.

(ii) Under the terms of Trust P, all trust income is payable annually to B, and no one has the power to appoint Trust P principal to any person other than B. A's children, who are all younger than B, are the sole remainder beneficiaries of the Trust P. No other person has a beneficial interest in Trust P. Under the terms of the Trust P, B has the power, exercisable annually, to compel the trustee to withdraw from A's account balance in Plan X an amount equal to the income earned on the assets held in A's account in Plan X during the calendar year and to distribute that amount through Trust P to B. Plan X contains no prohibition on withdrawal from A's account of amounts in excess of the annual required minimum distributions under section 401(a)(9). In accordance with the terms of Plan X, the trustee of Trust P elected during May of calendar year 2015 to satisfy section 401(a)(9), to receive annual required minimum distributions using the life expectancy rule in section 401(a)(9)(B)(iii) for distributions over a distribution period equal to B's life expectancy. If B exercises the withdrawal power, the trustee must withdraw from A's account and distribute to B the greater of the amount of income earned in the account during the calendar year or the required minimum distribution. However, under the terms of Trust P, and applicable state law, only the portion of the Plan X distribution received by the trustee equal to the income earned on assets held in A's account in Plan X is required to be distributed to B (along with any other trust income.)

(iii) Because some amounts distributed from A's account in Plan X to Trust P may be accumulated in Trust P during B's lifetime for the benefit of A's children, as remainder beneficiaries of Trust P, even though access to those amounts are delayed until after B's death, A's children are beneficiaries of A's account in Plan X in addition to B and B is not the sole beneficiary of A's account. Thus the designated beneficiary used to determine the distribution period from A's account in Plan X is the beneficiary with the shortest life expectancy. B's life expectancy is the shortest of all the potential beneficiaries of the testamentary trust's interest in A's account in Plan X (including remainder beneficiaries).

Thus, the distribution period for purposes of section 401(a)(9)(B)(iii) is B's life expectancy. Because B is not the sole beneficiary of the testamentary trust's interest in A's account in Plan X, the special rule in 401(a)(9)(B)(iv) is not available and the annual required minimum distributions from the account to Trust M must begin no later than the end of the calendar year immediately following the calendar year of A's death.

Example 3. (i) The facts are the same as Example 2 except that the testamentary trust instrument provides that all amounts distributed from A's account in Plan X to the trustee while B is alive will be paid directly to B upon receipt by the trustee of Trust P. (ii) In this case, B is the sole beneficiary of A's account in Plan X for purposes of determining the designated beneficiary under section 401(a)(9)(B)(iii) and (iv). No amounts distributed from A's account in Plan X to Trust P are accumulated in Trust P during B's lifetime for the benefit of any other beneficiary. Because B is the sole beneficiary of the testamentary trust's interest in A's account in Plan X, the annual required minimum distributions from A's account to Trust P must be distributed no later than the end of the calendar year in which A would have attained age 70½, rather than the calendar year immediately following the calendar year of A's death.

(d) Designations by beneficiaries. (1) If the plan provides (or allows the employee to specify) that, after the end of the calendar year following the calendar year in which the employee died, any person or persons have the discretion to change the beneficiaries of the employee, then, for purposes of determining the distribution period after the employee's death, the employee will be treated as not having designated a beneficiary. However, such discretion will not be found to exist merely because a beneficiary may designate a subsequent beneficiary for distributions of any portion of the employee's benefit after the beneficiary dies.

(2) This paragraph (d) is illustrated by the following example:

Example. The facts are the same as in Example 3 in paragraph (c)(5) of this A-7, except that, as permitted under the plan, D designates E as the beneficiary of any amount remaining after the death of D rather than C, making this designation. B is still disregarded in determining C's designated beneficiary for purposes of section 401(a)(9).

Q-8. If a portion of an employee's individual account is not vested as of the employee's required beginning date how is the determination of the required minimum distribution affected?

A-8. If the employee's benefit is in the form of an individual account, the benefit used to determine the required minimum distribution for any distribution calendar year will be determined in accordance with A-1 of this section without regard to whether or not all of the employee's benefit is vested. If any portion of the employee's benefit is not vested, distributions will be treated as being paid from the vested portion of the benefit first. If, as of the end of a distribution calendar year (or as of the employee's required beginning date, in the case of the employee's first distribution calendar year), the total amount of the employee's vested benefit is less than the required minimum distribution for the calendar year, only the vested portion, if any, of the employee's benefit is required to be distributed by the end of the calendar year (or, if applicable, by the employee's required beginning date). However, the required minimum distribution for the subsequent distribution calendar year must be increased by the sum of amounts not distributed in prior calendar years because the employee's vested benefit was less than the required minimum distribution (subject to the limitation that the required minimum distribution for that subsequent distribution calendar year will not exceed the vested portion of the employee's benefit). In such case, an adjustment for the additional amount distributed which corresponds to the adjustment described in paragraph (c)(2) of this section will be made to the account used to determine the required minimum distribution for that calendar year.

§1.401(a)(9)-6 Required minimum distributions as annuity payments.

Q-1. How must annuity distributions under a defined benefit plan be paid in order to satisfy section 401(a)(9)?

A-1. (i) In order to satisfy section 401(a)(9), annuity distributions under a defined benefit plan must be paid in periodic payments made at intervals not longer than one year (payment intervals) for a life (or lives), or over a period certain not longer than a life expectancy (or joint life and last survivor expectancy) described in section 401(a)(9)(A)(ii) or section 401(a)(9)(B)(iii), whichever is applicable. The life expectancy (or joint life and last survivor expectancy) for purposes of determining the length of the period certain will be determined in accordance with A-3 of this section.

(ii) If the employee's benefit has some balance in the account after the death of the employee and the period certain may not be lengthened even if the period certain is shorter than the maximum permitted. Life annuity payments must satisfy the minimum distribution incidental benefit requirements of A-2 of this section. All annuity payments (life and period certain) also must either be nonincreasing or increase only as follows:

(1) With any percentage increase in a specified and generally recognized cost-of-living index.

(2) To the extent of the reduction in the amount of the employee's payments to provide for a survivor benefit upon death, but only if the beneficiary whose life was being used to determine the
period described in section 401(a)(9)(A)(ii) over which payments were being made dies or is no longer the employee’s beneficiary pursuant to a qualified domestic relations order within the meaning of section 414(p).

(3) To provide cash refunds of employee contributions upon the employee’s death;

(4) Because of an increase in benefits under the plan.

(b) The annuity may be a life annuity (or joint and survivor annuity) with a period certain if the life (or lives, if applicable) and period certain each meet the requirements of paragraph (a) of this A-1. For purposes of this section, if distribution is permitted to be made over the lives of the employee and the designated beneficiary, references to life annuity include a joint and survivor annuity.

(c) Distributions under a variable annuity will not be found to be increasing merely because the amount of the payments varies with the investment performance of the underlying assets. However, the Commissioner may prescribe additional requirements applicable to such variable life annuities in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin. See §601.601(d)(2)(ii)(b) of this chapter.

(d)(1) Except as provided in (d)(2) of this A-1, annuity payments must commence on or before the employee’s required beginning date (within the meaning of A-2 of §1.401(a)(9)—2). The first payment which must be made on or before the employee’s required beginning date must be the payment which is required for one payment interval. The second payment need not be made until the end of the next payment interval even if that payment interval ends in the next calendar year. Similarly, in the case of distributions commencing after death in accordance with section 401(a)(9)(B)(iii) and (iv), the first payment that must be made on or before the date determined under A-3(a) or (b) (whichever is applicable) of §1.401(a)(9)—3 must be the payment which is required for one payment interval. Payment intervals are the periods for which payments are received, e.g., bimonthly, monthly, semi-annually, or annually. All benefit accruals as of the last day of the first distribution calendar year must be included in the calculation of the amount of the life annuity payments for payment intervals ending on or after the employee’s required beginning date.

(2) In the case of an annuity contract purchased after the required beginning date, the first payment interval must begin on or before the purchase date and the payment required for one payment interval must be made no later than the end of such payment interval.

(3) This paragraph (d) is illustrated by the following example:

Example. A defined benefit plan (Plan X) provides monthly payments of $500 for the life of unmarried participants with a 10-year period certain. An unmarried participant (A) in Plan X attains age 70 1/2 in 2001. In order to meet the requirements of this paragraph, the first payment which must be made on behalf of A on or before April 1, 2002, will be $500 and the payments must continue to be made in monthly payments of $500 thereafter for the life and 10-year certain period.

(e) If distributions from a defined benefit plan are not in the form of an annuity, the employee’s benefit will be treated as an individual account for purposes of determining the required minimum distribution. See §1.401(a)(9)—5.

Q-2. How must distributions in the form of a life (or joint and survivor) annuity be made in order to satisfy the required minimum distribution (MDIB) requirement of section 401(a)(9)?

A-2. (a) Life annuity for employee. If the employee’s benefit is payable in the form of a life annuity for the life of the employee satisfying section 401(a)(9), the MDIB requirement of section 401(a)(9)(C) will be satisfied.

(b) Joint and survivor annuity, spouse beneficiary. If the employee’s sole beneficiary, as of the annuity starting date for annuity payments, is the employee’s spouse and the distributions satisfy section 401(a)(9) without regard to the MDIB requirement, the distributions to the employee will be deemed to satisfy the MDIB requirement of section 401(a)(9)(C).

(c) Joint and survivor annuity, nonspouse beneficiary—(1) Explanation of rule. If distributions commence under a distribution option that is in the form of a joint and survivor annuity for the joint lives of the employee and a beneficiary other than the employee’s spouse, the MDIB requirement will not be satisfied as of the date distributions commence unless the distribution option provides that annuity payments be made to the employee on and after the employee’s required beginning date will satisfy the conditions of this paragraph. The periodic annuity payment payable to the survivor must not at any time on and after the employee’s required beginning date exceed the applicable percentage of the annuity payment payable to the employee using the table below. Thus, this requirement must be satisfied with respect to any benefit increase after such date, including increases to reflect increases in the cost of living. The applicable percentage is based on the excess of the age of the employee over the age of the beneficiary as of their attained ages as of their birthdays in a calendar year. If the employee has more than one beneficiary, the applicable percentage will be the percentage using the age of the youngest beneficiary.

Additionally, the amount of the annuity payments must satisfy A-1 of this section.

(2) Table.

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<thead>
<tr>
<th>Excess of age of employee over age of beneficiary</th>
<th>Applicable percentage</th>
</tr>
</thead>
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(3) Example. This paragraph (c) is illustrated by the following example:
Example. Distributions commence on January 1, 2001 to an employee (Z), born March 1, 1935, after retirement at age 65. Z’s daughter (Y), born February 5, 1965, is Z’s beneficiary. The distributions are in the form of a joint and survivor annuity for the lives of Z and Y with payments of $500 a month to Z and upon Z’s death of $500 a month to Y, i.e., the projected monthly payment to Y is 100 percent of the monthly amount payable to Z. There is no provision under the option for a change in the projected payments to Y as of April 1, 2006, Z’s required beginning date. Consequently, as of January 1, 2001, the date annuity distributions commence, the plan does not satisfy the MDIB requirement in operation because, as of such date, the distribution option provides that, as of Z’s required beginning date, the monthly payment to Y upon Z’s death will exceed 80 percent of Z’s monthly payment (the maximum percentage for a difference of ages of 30 years).

(d) Period certain and annuity features. If a distribution form includes a life annuity and a period certain, the amount of the annuity payments payable to the employee must satisfy paragraph (c) of this A-2, and the period certain may not exceed the period determined under A-3 of this section.

Q-3. How long is a period certain under an annuity contract permitted to extend?

A-3. (a) Distributions commencing during the employee’s life—(1) Spouse beneficiary. If an employee’s spouse is the employee’s sole beneficiary as of the annuity starting date, the period certain for annuity distributions commencing during the life of an employee with an annuity starting date on or after the employee’s required beginning date is not permitted to exceed the joint life and last survivor expectancy of the employee and the spouse using the age of the employee and spouse as of their birthdays in the calendar year that contains the annuity starting date. (2) Nonspouse beneficiary. If an employee’s surviving spouse is not the employee’s sole beneficiary as of the annuity starting date, the period certain for any annuity distributions during the life of the employee with an annuity starting date on or after the employee’s required beginning date is not permitted to exceed the shorter of the applicable distribution period for the employee (determined in accordance with the table in A-4(a)(2) of § 1.401(a)(9)-5 for the calendar year that contains the annuity starting date) or the joint life and last survivor expectancy of the employee and the employee’s designated beneficiary, determined using the designated beneficiary as of the annuity starting date and using their ages as of their birthdays in the calendar year that contains the annuity starting date. See A-10 for the rule for annuity payments with an annuity starting date before the required beginning date.

(b) Life expectancy rule. (1) If annuity distributions commence after the death of the employee under the life expectancy rule under section 401(a)(9)(ii) or (iv), the period certain for any distributions commencing after death cannot exceed the applicable distribution period determined under A-5(b) of § 1.401(a)(9)-5 for the distribution calendar year that contains the annuity starting date. (2) If the annuity starting date is in a calendar year before the first distribution calendar year, the period certain may not exceed the life expectancy of the designated beneficiary using the beneficiary’s age in the year that contains the annuity starting date.

Q-4. May distributions be made from an annuity contract which is purchased from an insurance company?

A-4. Yes. Distributions may be made from an annuity contract which is purchased with the employee’s benefit by the plan from an insurance company and which makes payments that satisfy the provisions of this section. In the case of an annuity contract purchased from an insurance company, there is also an exception to the nonincreasing requirement in A-1(a) of this section for an increase to provide a cash refund upon the employee’s death equal to the excess of the amount of the premiums paid for the contract over the prior distributions. If the payments actually made under the annuity contract do not meet the requirements of section 401(a)(9), the plan fails to satisfy section 401(a)(9).

Q-5. In the case of annuity distributions under a defined benefit plan, how must additional benefits which accrue after the employee’s required beginning date be distributed in order to satisfy section 401(a)(9)?

A-5. (a) In the case of annuity distributions under a defined benefit plan, if any additional benefits accrue after the employee’s required beginning date, distribution of such amount as a separate identifiable component must commence in accordance with A-1 of this section beginning with the first payment interval ending in the calendar year immediately following the calendar year in which such amount accrues. (b) A plan will not fail to satisfy section 401(a)(9) merely because there is an administrative delay in the commencement of the distribution of the separate identifiable component, provided that the actual payment of such amount commences as soon as practicable but not later than by the end of the first calendar year following the calendar year in which the additional benefit accrues, and that the total amount paid during such first calendar year is not less than the total amount that was required to be paid during that year under A-5(a) of this section.

Q-6. If a portion of an employee’s benefit is not vested as of the employee’s required beginning date, how is the determination of the required minimum distribution affected?

A-6. In the case of annuity distributions from a defined benefit plan, if any portion of the employee’s benefit is not vested as of December 31 of a distribution calendar year (or as of the employee’s required beginning date in the case of the employee’s first distribution calendar year), the portion which is not vested as of such date will be treated as not having accrued for purposes of determining the required minimum distribution for that distribution calendar year. When an additional portion of the employee’s benefit becomes vested, such portion will be treated as an additional accrual. See A-5 of this section for the rules for distributing benefits which accrue under a defined benefit plan after the employee’s required beginning date.

Q-7. If an employee retires after the calendar year in which the employee attains age 70½, for what period must the employee’s accrued benefit under a defined benefit plan be actuarially increased?

A-7. (a) Actuarial increase starting date. If an employee (other than a 5-percent owner) retires after the calendar year in which the employee attains age 70½, in order to satisfy section 401(a)(9)(C)(iii), the employee’s accrued benefit under a defined benefit plan must be actuarially increased to take into account any period after age 70½ in which the employee was not receiving any benefits under the plan. The actuarial increase required to satisfy section 401(a)(9)(C)(iii) must be provided for the period starting on April 1 following the calendar year in which the employee attains age 70½.

(b) Actuarial increase ending date. The period for which the actuarial increase must be provided ends on the date on which benefits commence after retirement in an amount sufficient to satisfy section 401(a)(9).

(c) Nonapplication to plan providing same required beginning date for all employees. If as permitted under A-2(e) of § 1.401(a)(9)-2, a plan provides that the required beginning date for purposes of section 401(a)(9) for all employees is April 1 of the calendar year following the calendar year in which the employee attained age 70½ (regardless of whether the employee is a 5-percent owner) and the plan makes distributions
in an amount sufficient to satisfy section 401(a)(9) using that required beginning date, no actuarial increase is required under section 401(a)(9)(C)(iii).

(d) Nonapplication to defined contribution plans. The actuarial increase required under this A-7 does not apply to defined contribution plans.

(e) Nonapplication to governmental and church plans. The actuarial increase required under this A-7 does not apply to a governmental plan (within the meaning of section 414(d)) or a church plan. For purposes of this paragraph, the term church plan means a plan maintained by a church for church employees, and the term church means any church (as defined in section 3121(w)(3)(A)) or qualified church-controlled organization (as defined in section 3121(w)(3)(B)).

Q-8. What amount of actuarial increase is required under section 401(a)(9)?

A-8. In order to satisfy section 401(a)(9)(C)(iii), the retirement benefits payable with respect to an employee as of the end of the period for actuarial increases (described in A-7 of this section) must be no less than: the actuarial equivalent of the employee’s retirement benefits that would have been payable as of the date the actuarial increase must commence under A-7(a) of this section if benefits had commenced on that date; plus the actuarial equivalent of any additional benefits accrued after that date; reduced by the actuarial equivalent of any distributions made with respect to the employee’s retirement benefits after that date. Actuarial equivalence is determined using the plan’s assumptions for determining actuarial equivalence for purposes of satisfying section 411.

Q-9. How does the actuarial increase required under section 401(a)(9)(C)(iii) relate to the actuarial increase required under section 411?

A-9. No. If any of an employee’s accrued benefit is nonforfeitable as required under section 411, a defined benefit plan must make an actuarial adjustment to an accrued benefit the payment of which is deferred past normal retirement age. The only exception to this rule is that generally no actuarial adjustment is required to reflect the period during which a benefit is suspended as permitted under section 203(a)(3)(B) of the Employee Retirement Income Security Act of 1974 (ERISA). The actuarial increase required under section 401(a)(9) for the period described in A-7 of this section is generally the same as, and not in addition to, the actuarial increase required for the same period under section 411 to reflect any delay in the payment of retirement benefits after normal retirement age. However, unlike the actuarial increase required under section 411, the actuarial increase required under section 401(a)(9)(C) must be provided even during the period during which an employee’s benefit has been suspended in accordance with ERISA section 203(a)(3)(B).

Q-10. What rule applies if distributions commence to an employee on a date before the employee’s required beginning date over a period permitted under section 401(a)(9)(A)(ii) and the distribution form is an annuity under which distributions are made in accordance with the provisions of A-1 (and if applicable A-4) of this section?

A-10. (a) General rule: If distributions irrevocably (except for acceleration) commence to an employee on a date before the employee’s required beginning date, and, if applicable, A-4 of this section, the annuity starting date will be treated as the required beginning date for purposes of applying the rules of this section and 1.401(a)(9)-3. Thus, for example, the designated beneficiary distributions will be determined as of the annuity starting date. Similarly, if the employee dies after the annuity starting date but before the annuity starting date determined under A-2 of 1.401(a)(9)-2, after the employee’s death, the remaining portion of the employee’s interest must continue to be distributed in accordance with this section over the remaining period over which distributions commenced (single or joint lives and, if applicable, period certain).

(b) Period certain. If as of the employee’s birthday in the year that contains the annuity starting date, the age of the employee is under 70, the following rules apply in applying the rule in paragraph (a)(2) of A-3 of this section. The applicable distribution period for the employee (determined in accordance with the table in A-4(a)(2) of 1.401(a)(9)-5) is 26.2 plus the difference between 70 and the age of the employee as of the employee’s birthday in the year that contains the annuity starting date. Q-11. What rule applies if distributions commence irrevocably (except for acceleration) to the surviving spouse of an employee over a period permitted under section 401(a)(9)(B)(iii)(II) before the date on which distributions are required to commence and the distribution form is an annuity under which distributions are made as of the date distributions commence in accordance with the provisions of A-1 (and if applicable A-4) of this section.

A-11. If distributions commence irrevocably (except for acceleration) to the surviving spouse of an employee over a period permitted under section 401(a)(9)(B)(iii)(II) before the date on which distributions are required to commence and the distribution form is an annuity under which distributions are made as of the date distributions commence in accordance with the provisions of A-1 (and if applicable A-4) of this section, distributions will be considered to have begun on the actual commencement date for purposes of section 401(a)(9)(B)(iv)(II).

Consequently, in such case, A-5 of 1.401(a)(9)-3 and section 401(a)(9)(B)(i) and (iii) will not apply upon the death of the surviving spouse as though the surviving spouse were the employee. Instead, the annuity distributions must continue to be made, in accordance with the provisions of A-1 (and if applicable A-4) of this section over the remaining period over which distributions commenced (single life and, if applicable, period certain).

§ 1.401(a)(9)-7 Rollovers and Transfers.

Q-1. If an amount is distributed by one plan (distributing plan) and is rolled over to another plan, is the benefit or the required minimum distribution under the distributing plan affected by the rollover?

A-1. No. If an amount is distributed by one plan (distributing plan) and is rolled over to another plan, the amount distributed is still treated as a distribution by the distributing plan for purposes of section 401(a)(9), notwithstanding the rollover.

Q-2. If an amount is distributed by one plan (distributing plan) and is rolled over to another plan (receiving plan), how are the benefit and the required minimum distribution under the receiving plan affected?

A-2. If an amount is distributed by one plan (distributing plan) and is rolled over to another plan (receiving plan), the benefit of the employee under the receiving plan is increased by the amount rolled over. However, the distribution has no impact on the required minimum distribution to be made by the receiving plan for the calendar year in which the rollover is received.

But, if the required minimum distribution is required to be made by the receiving plan for the following calendar year, the rollover amount must be considered to be part of the

APPENDIX H: PROPOSED REGULATIONS § 1.401(a)(9)
employee’s benefit under the receiving plan. Consequently, for purposes of determining any required minimum distribution for the calendar year immediately following the calendar year in which the amount rolled over is received by the receiving plan, in the case in which the amount rolled over is received after the last valuation date in the calendar year under the receiving plan, the benefit of the employee as of such valuation date, adjusted in accordance with A–3 of §1.401(a)(9)–5, will be increased by the rollover amount valued as of the date of receipt. For purposes of calculating the benefit under the receiving plan pursuant to the preceding sentence, if the amount rolled over is received by the receiving plan in a different calendar year from the calendar year in which it is distributed by the distributing plan, the amount rolled over is deemed to have been received by the receiving plan in the calendar year in which it was distributed by the distributing plan.

Q–3. In the case of a transfer of an amount of an employee’s benefit from one plan (transferor plan) to another plan (transferee plan), are there any special rules for satisfying the required minimum distribution requirement or determining the employee’s benefit under the transferor plan?

A–3. (a) In the case of a transfer of an amount of an employee’s benefit from one plan to another, the transfer is not treated as a distribution by the transferor plan for purposes of section 401(a)(9). Instead, the benefit of the employee under the transferor plan is decreased by the amount transferred. However, if any portion of an employee’s benefit is transferred in a distribution year with respect to that employee, in order to satisfy section 401(a)(9), the transferor plan must determine the amount of the required minimum distribution with respect to that employee for the calendar year of the transfer using the employee’s benefit under the transferor plan before the transfer. Additionally, if any portion of an employee’s benefit is transferred in the employee’s second distribution calendar year but on or before the employee’s required beginning date, in order to satisfy section 401(a)(9), the transferor plan must determine the amount of the required minimum distribution requirement for the employee’s first distribution calendar year based on the employee’s benefit under the transferor plan before the transfer. The transferor plan may satisfy the required minimum distribution requirement for the calendar year of the transfer (and the prior year if applicable) by segregating the amount which must be distributed from the employee’s benefit and not transferring that amount. Such amount may be retained by the transferor plan and distributed on or before the date required.

(b) For purposes of determining any required minimum distribution for the calendar year immediately following the calendar year in which the transfer occurs, in the case of a transfer after the last valuation date for the calendar year of the transfer under the transferor plan, the benefit of the employee as of such valuation date, adjusted in accordance with A–3 of §1.401(a)(9)–5, will be decreased by the amount transferred, valued as of the date of the transfer.

Q–4. If an amount of an employee’s benefit is transferred from one plan (transferor plan) to another plan (transferee plan), how are the benefit and the required minimum distribution under the transferee plan affected?

A–4. In the case of a transfer from one plan (transferor plan) to another plan (transferee plan), the general rule is that the benefit of the employee under the transferor plan is increased by the amount transferred. The transferor plan does not have an impact on the required minimum distribution to be made by the transferee plan in the calendar year in which the transfer is received. However, if a required minimum distribution is required from the transferee plan for the following calendar year, the transferred amount must be considered to be part of the employee’s benefit under the transferee plan. Consequently, for purposes of determining any required minimum distribution for the calendar year immediately following the calendar year in which the transfer occurs, in the case of a transfer after the last valuation date of the transferee plan in the transferor calendar year, the benefit of the employee under the receiving plan valued as of such valuation date, adjusted in accordance with A–3 of §1.401(a)(9)–5, will be increased by the amount transferred valued as of the date of the transfer.

Q–5. How are a spinoff, merger or consolidation (as defined in §1.1414–1) treated for purposes of determining an employee’s benefit and required minimum distribution under section 401(a)(9)?

A–5. For purposes of determining an employee’s benefit and required minimum distribution under section 401(a)(9), a spinoff, a merger, or a consolidation (as defined in §1.1414–1) will be treated as a transfer of the benefits of the employees involved. Consequently, the benefit and required minimum distribution of each employee involved under the transferor and transferee plans will be determined in accordance with A–3 and A–4 of this section.

§1.401(a)(9)–8 Special rules.

Q–1. What distribution rules apply if an employee is a participant in more than one plan?

A–1. If an employee is a participant in more than one plan, the plans in which the employee participates are not permitted to be aggregated for purposes of testing whether the distribution requirements of section 401(a)(9) are met. The distribution of the benefit of the employee is treated in the case of a defined benefit plan as if separately met the requirements of section 401(a)(9). For this purpose, a plan described in section 414(k) is treated as two separate plans, a defined contribution plan to the extent benefits are based on an individual account and a defined benefit plan with respect to the remaining benefits.

Q–2. If an employee’s benefit under a plan is divided into separate accounts (or segregated shares in the case of a defined benefit plan) must the distribution rules in section 401(a)(9) and these regulations apply separately to each separate account (or segregated share)?

A–2. (a) Except as otherwise provided in paragraphs (b) and (c) of this A–2, if an employee’s account under a defined contribution plan is divided into separate accounts (or in the case of a defined benefit plan) is divided into segregated shares in the case of a defined benefit plan) under the plan, the separate accounts (or segregated shares) will be aggregated for purposes of satisfying the requirements in section 401(a)(9). Thus, except as otherwise provided in paragraphs (b) and (c) of this A–2, all separate accounts, including a separate account for nondeductible employee contributions (under section 72(d)(2)) or plan participation (under section 72(d)(3)), or any voluntary employee contributions (as defined in section 219(e)), will be aggregated for purposes of section 401(a)(9).

(b) If, for lifetime distributions, as of an employee’s required beginning date (or the beginning of any distribution calendar year beginning after the employee’s required beginning date), or in the case of distributions under section 401(a)(9)(B)(ii) or (iii) and (iv), as of the end of the year following the year containing the employee’s (or spouse’s, where applicable) date of death, the beneficiaries with respect to a separate account (or segregated share in the case of a defined benefit plan) under the plan differ from the beneficiaries with respect to the other separate accounts (or segregated shares)
of the employee under the plan, such separate account (or segregated share) under the plan need not be aggregated with other separate accounts (or segregated shares) under the plan in order to determine whether the distributions from such separate account (or segregated share) under the plan satisfy section 401(a)(9). Instead, the distributions under section 401(a)(9)(ii) may separately apply to such separate account (or segregated share) under the plan. For example, if, in the case of a distribution described in section 401(a)(9)(iii) and (iv), the only beneficiary of a separate account (or segregated share) under the plan is the employee’s surviving spouse, and beneficiaries other than the surviving spouse are designated with respect to the other separate accounts of the employee, distribution of the spouse’s separate account (or segregated share) under the plan must commence at an earlier date than the date determined under the first sentence in A-3(b) of § 1.401(a)(9)–3, even if distribution of the other separate accounts (or segregated shares) under the plan must commence at an earlier date. In the case of a distribution after the death of an employee to which section 401(a)(9)(B)(i) does not apply, distribution from a separate account (or segregated share) of an employee may be made over a beneficiary's life expectancy in accordance with section 401(a)(9)(B)(iii) and (iv) even through distributions from other separate accounts (or segregated shares) under the plan with different beneficiaries are being made in accordance with the five-year rule in section 401(a)(9)(B)(ii).

(c) A portion of an employee’s account balance under a defined contribution plan is permitted to be used to purchase an annuity contract with a remaining amount maintained in the separate account. In that case, the separate account under the plan must be distributed in accordance with § 1.401(a)(9)–5 in order to satisfy section 401(a)(9) and the annuity payments under the annuity contract must satisfy § 1.401(a)(9)–6 in order to satisfy section 401(a)(9).  

A-3. (a) For purposes of section 401(a)(9), a separate account in an individual account component of an employee’s benefit determined by an acceptable separate accounting including allocating investment gains and losses, and contributions and forfeitures, on a pro rata basis in a reasonable and consistent manner between such portion and any other benefits. Further, the amounts of each such portion of the benefit will be separately determined for purposes of determining the amount of the required minimum distribution in accordance with § 1.401(a)(9)–5.  

(b) A benefit in a defined benefit plan is separated into segregated shares if it consists of separate identifiable components which may be separately distributed.  

Q-4. Must a distribution that is required by section 401(a)(9) to be made by the required beginning date to an employee or that is required by section 401(a)(9)(B)(iii) and (iv) to be made by the required time to a designated beneficiary who is a surviving spouse be made notwithstanding the failure of the employee, or spouse where applicable, to consent to a distribution while a benefit is immediately distributable?  

A-4. Yes. Section 411(a)(11) and section 170(a) (see §§ 1.411(a)(11)–1(c) and 1.170(a)-1(c)) require employee and spousal consent to certain distributions of plan benefits while such benefits are immediately distributable. If an employee’s or a spouse’s retirement age is later than the required beginning date for the commencement of distributions under section 401(a)(9) and, therefore, benefits are still immediately distributable, the plan must, nevertheless, distribute plan benefits to the participant (or where applicable, to the spouse) in a manner that satisfies the requirements of section 401(a)(9). Section 401(a)(9) must be satisfied even though the participant (or spouse, where applicable) fails to consent to the distribution. In such a case, the plan may distribute in the form of a qualified joint and survivor annuity (QJSA) or in the form of a qualified preretirement survivor annuity (QPSA) and the consent requirements of sections 411(a)(11) and 417(e) are deemed to be satisfied if the plan has made reasonable efforts to obtain consent from the participant (or spouse if applicable) and if the distribution otherwise meets the requirements of section 417. If, because of section 401(a)(11)(B), the plan is not required to distribute in the form of a QJSA to a participant or a QPSA to a surviving spouse, the plan may distribute the required minimum distribution amount required at the time required to satisfy section 401(a)(9) and the consent requirements of sections 411(a)(11) and 417(e) are deemed to be satisfied if the plan has made reasonable efforts to obtain consent from the participant (or spouse if applicable) and if the distribution otherwise meets the requirements of section 417.  

Q-5. Who is an employee’s spouse or surviving spouse for purposes of section 401(a)(9)?  

A-5. Except as otherwise provided in A-6(a) (in the case of distributions of a portion of an employee’s benefit payable to a former spouse of an employee pursuant to a qualified domestic relations order), for purposes of section 401(a)(9), an individual is a spouse or surviving spouse of an employee if such individual is treated as the employee’s spouse under applicable state law. In the case of distributions after the death of an employee, for purposes of determining whether, under the life expectancy rule in section 401(a)(9)(B)(iii) and (iv), the provisions of section 401(a)(9)(B)(iv) apply, the spouse of the employee is determined as of the date of death of the employee.  

Q-6. In order to satisfy section 401(a)(9), are there any special rules which apply to the distribution of all or a portion of an employee’s benefit payable to an alternate payee pursuant to a qualified domestic relations order as defined in section 414(p) (QDRO)?  

A-6. (a) A former spouse to whom all or a portion of the employee’s benefit is payable pursuant to a QDRO will be treated as a spouse (including a surviving spouse) of the employee for purposes of section 401(a)(6), including the minimum distribution incidental benefit requirement, regardless of whether the QDRO specifically provides that the former spouse is treated as the spouse for purposes of sections 401(a)(11) and 417.  

(b) If a QDRO provides that an employee’s benefit is to be divided and a portion is to be allocated to an alternate payee, such portion will be treated as a separate account (or segregated share) which separately must satisfy the requirements of section 401(a)(9) and may not be aggregated with other separate accounts (or segregated shares) of the employee for purposes of satisfying section 401(a)(9). Except as otherwise provided in paragraph (b) of this A-6, distribution of such separate account allocated to an alternate payee pursuant to a QDRO must be made in accordance with section 401(a)(9). For example, in general, distribution of such account will satisfy section 401(a)(9)(A) if required minimum distributions from such account during the employee’s lifetime begin not later than the employee’s required beginning date and the required minimum distribution is determined in accordance with § 1.401(a)(9)–5 for each distribution calendar year using an applicable distribution period determined under A-4 of § 1.401(a)(9)–5 using the age of the employee in the distribution calendar year for purposes of using the
table in A-4(a)(2) of § 1.401(a)(9)—5 if applicable or ages of the employee and spousal alternate payee if their joint life expectancy is longer than the distribution period using that table. The determination of whether distribution from such account after the death of the employee to the alternate payee will be made in accordance with section 401(a)(9)(B)(ii) or (iii) and (iv) will depend on whether distributions have begun as determined under A-5 or § 1.401(a)(9)—2 (which provides, in general, that distributions are not treated as having begun until the employee’s required beginning date even though payments may actually have begun before that date). For example, if the alternate payee dies before the employee and distribution of the separate account allocated to the alternate payee pursuant to the QDRO is to be made to the alternate payee’s beneficiary, such beneficiary may be treated as a designated beneficiary for purposes of determining the required minimum distribution required from such account after the death of the employee if the beneficiary of the alternate payee is an individual and if such beneficiary is a beneficiary under the plan or specified to or in the plan. Specification in or pursuant to the QDRO will also be treated as specification to the plan.

(2) Distribution of the separate account allocated to an alternate payee pursuant to a QDRO satisfy the requirements of section 401(a)(9)(A)(ii) if such account is to be distributed, beginning not later than the employee’s required beginning date, over the life of the alternate payee (or over a period not exceeding beyond the life expectancy of the alternate payee). Also, if the plan permits the employee to elect whether distribution upon the death of the employee will be made in accordance with the five-year rule in section 401(a)(9)(B)(ii) or the life expectancy rule in section 401(a)(9)(B)(iii) and (iv) pursuant to A-4(c) of § 1.401(a)(9)—3, such election is to be made only by the alternate payee for purposes of distributing the separate account allocated to the alternate payee pursuant to the QDRO. If the alternate payee dies after distribution of the separate account allocated to the alternate payee pursuant to a QDRO has begun (determined under A-5 of § 1.401(a)(9)—2) but before the employee dies, distribution of the remaining portion of that portion of the benefit allocated to the alternate payee must be made in accordance with the rules in § 1.401(a)(9)—5 or § 1.401(a)(9)—6 for distributions during the life of the employee. Only after the death of the employee is the amount of the required minimum distribution determined in accordance with the rules that apply after the death of the employee.

(c) If a QDRO does not provide that an employee’s benefit is to be divided but provides that a portion of an employee’s benefit (otherwise payable to the employee) is to be paid to an alternate payee, such portion will not be treated as a separate account (or segregated share) of the employee. Instead, such portion will be aggregated with any amount distributed to the employee and will be treated as having been distributed to the employee for purposes of determining whether the required minimum distribution requirement has been satisfied with respect to that employee.

Q-7. Will a plan fail to satisfy section 401(a)(9) where it is not legally permitted to distribute to an alternate payee all or a portion of an employee’s benefit payable to an alternate payee pursuant to a QDRO within the period specified in section 414(p)(7)?

A-7. A plan will not fail to satisfy section 401(a)(9) merely because it fails to distribute a required amount during the period in which the issue of whether a domestic relations order is a QDRO is being determined pursuant to section 414(p)(7), provided that the period does not extend beyond the 18-month period described in section 414(p)(7)(E). To the extent that a distribution otherwise required under section 401(a)(9) is not made during this period, this amount and any additional amount accrued during this period will be treated as though it is not vested during the period and any distributions with respect to such amounts must be made under the relevant rules for nonvested benefits described in either A-8 of § 1.401(a)(9)—5 or A-6 of § 1.401(a)(9)—6.

Q-8. Will a plan fail to satisfy section 401(a)(9) where an individual’s distribution from the plan is less than the amount otherwise required to satisfy section 401(a)(9) under § 1.401(a)(9)—5 or 1.401(a)(9)—6 because distributions were being paid under an annuity contract issued by a life insurance company in state insurer delinquency proceedings and have been reduced or suspended by reasons of such state proceedings?

A-8. A plan will not fail to satisfy section 401(a)(9) merely because an individual’s distribution from the plan is less than the amount otherwise required to satisfy section 401(a)(9) under § 1.401(a)(9)—5 or 1.401(a)(9)—6 because distributions were being paid under an annuity contract issued by a life insurance company in state insurer delinquency proceedings and have been reduced or suspended by reasons of such state proceedings. To the extent that a distribution otherwise required under section 401(a)(9) is not made during the state insurer delinquency proceedings, this amount and any additional amount accrued during this period will be treated as though it is not vested during the period and any distributions with respect to such amounts must be made under the relevant rules for nonvested benefits described in either A-8 of § 1.401(a)(9)—5 or A-6 of § 1.401(a)(9)—6.

Q-9. Will a plan fail to qualify as a pension plan within the meaning of section 401(a) solely because the plan permits distributions to commence to an employee on or after April 1 of the calendar year following the calendar year in which the employee attains age 70 1/2 even though the employee has not retired or attained the normal retirement age under the plan as of the date on which such distributions commence?

A-9. No. A plan will not fail to qualify as a pension plan within the meaning of section 401(a) solely because the plan permits distributions to commence to an employee on or after April 1 of the calendar year following the calendar year in which the employee attains age 70 1/2 even though the employee has not retired or attained the normal retirement age under the plan as of the date on which such distributions commence. This rule applies without regard to whether or not the employee is a 5-percent owner with respect to the plan year ending in the calendar year in which distributions commence.

Q-10. Is the distribution of an annuity contract a distribution for purposes of section 401(a)(9)?

A-10. The distribution of an annuity contract is not a distribution for purposes of section 401(a)(9).

Q-11. Will a payment by a plan after the death of an employee fail to be treated as a distribution for purposes of section 401(a)(9) solely because it is made to an estate or a trust?

A-11. A payment by a plan after the death of an employee will not fail to be treated as a distribution for purposes of section 401(a)(9) solely because it is made to an estate or a trust. As a result, the estate or trust which receives a payment from a plan after the death of an employee need not distribute the amount of such payment to the beneficiaries of the estate or trust in accordance with section 401(a)(9)(B).

However, pursuant to A-3 of § 1.401(a)(9)—4, distribution to the estate must satisfy the five-year rule in section 401(a)(9)(B)(iii) if the distribution to the employee had not begun (as defined in...
A-6 of § 1.401(a)(9)-2 as of the employee's date of death, and pursuant to A-3 of § 1.401(a)(9)-4, an estate may not be designated beneficiary. See A-5 and A-6 of § 1.401(a)(9)-4 for provisions under which beneficiaries of a trust with respect to the trust's interest in an employee's benefits are treated as having been designated as beneficiaries of the employee under the plan.

Q-12. Will a plan fail to satisfy section 411(d)(6) if the plan has provisions that do not satisfy section 401(a)(9)?

A-12. Nothing in section 401(a)(9) permits a plan to eliminate for all participants a benefit option that could not otherwise be eliminated pursuant to section 411(d)(6). However, a plan must provide that, notwithstanding any other plan provisions, it will not distribute benefits under any option that does not satisfy section 401(a)(9). See A-3 of § 1.401(a)(9)-1. Thus, the plan must either satisfy section 411(d)(6), or provide that a participant's benefits are treated as having been designated as beneficiaries of the employee under the plan.

Q-13. Is a plan disqualified merely because it pays benefits under a designation made before January 1, 1984, in accordance with section 422(b) of the Tax Equity and Fiscal Responsibility Act (TEFRA)?

A-13. No. Even though the distribution requirements added by TEFRA were retroactively repealed by the Tax Reform Act of 1984 (TRA of 1984), the transitional election rule in section 422(b) was preserved. Satisfaction of the spousal consent requirements of section 417(a) and (e) (added by the Retirement Equity Act of 1984) will not be considered a revocation of the pre-1984 designation. However, sections 401(a)(11) and 417 must be satisfied with respect to any distribution subject to those sections. The election provided in section 422(b) of TEFRA is hereafter referred to as a section 422(b) election.

Q-14. In the case in which an amount is transferred from one plan (transferor plan) to another plan (transferee plan), may the transferee plan distribute the amount transferred in accordance with a section 422(b)(2) election made under either the transferor plan or the transferee plan?

A-14. (a) In the case in which an amount is transferred from one plan to another plan, the amount transferred may be distributed in accordance with a section 422(b)(2) election made under the transferor plan if the employee did not elect to have the amount transferred and if the amount transferred is separately accounted for by the transferee plan. However, only the benefit attributable to the amount transferred, plus earnings thereon, may be distributed in accordance with the section 422(b)(2) election made under the transferor plan. If the employee elected to have the amount transferred, the transfer will be treated as a distribution and rollover of the amount transferred for purposes of this section.

(b) In the case in which an amount is transferred from one plan to another plan, the amount transferred may not be distributed in accordance with a section 422(b)(2) election made under the transferee plan. If a section 422(b)(2) election was made under the transferee plan, the amount transferred must be separately accounted for. If the amount transferred is not separately accounted for under the transferee plan, the section 424(b)(2) election under the transferee plan is revoked and section 401(a)(9) will apply to subsequent distributions by the transferee plan.

(c) A merger, spinoff, or consolidation, as defined in § 1.414(l)-1(b), will be treated as a transfer for purposes of the section 424(b)(2) election.

Q-15. If an amount is distributed by one plan (distributing plan) and rolled over into another plan (receiving plan), may the receiving plan distribute the amount rolled over in accordance with a section 424(b)(2) election made under either the distributing plan or the receiving plan?

A-15. No. If an amount is distributed by one plan and rolled over into another plan, the receiving plan must distribute the amount rolled over in accordance with section 401(a)(9) whether or not the employee made a section 424(b)(2) election under the distributing plan. Further, if the amount rolled over was not distributed in accordance with the election, the election under the distributing plan is revoked and section 401(a)(9) will apply to all subsequent distributions by the distributing plan. Finally, if the employee made a section 424(b)(2) election under the receiving plan and such election is still in effect, the amount rolled over must be separately accounted for under the receiving plan and distributed in accordance with section 401(a)(9). If amounts rolled over are not separately accounted for, any section 424(b)(2) election under the receiving plan is revoked and section 401(a)(9) will apply to subsequent distributions by the receiving plan.

Q-16. May a section 424(b)(2) election be revoked after the date by which distributions are required to commence in order to satisfy section 401(a)(9) and this section of the regulations? A-16. Yes. A section 424(b)(2) election may be revoked after the date by which distributions are required to commence in order to satisfy section 401(a)(9) and this section of the regulations. However, if the section 424(b)(2) election is revoked after the date by which distributions are required to commence in order to satisfy section 401(a)(9) and this section of the regulations and the total amount of the distributions from the plan is not yet distributed, the plan could be treated as having been required to be made prior to the date of the revocation in order to satisfy section 401(a)(9), but for the section 424(b)(2) election, have not been made, the trust must distribute by the end of the calendar year following the calendar year in which the revocation occurs the total amount not yet distributed which was required to have been distributed to satisfy the requirements of section 401(a)(9) and continue distributions in accordance with such requirements.

Par. 3-4. Section 1.401(b)-2 is added to read as follows:

§ 1.401(b)-2 Required minimum distributions from annuity contracts purchased, or custodial accounts or retirement income accounts established, by a section 501(c)(3) organization or a public school.

Q-1. Are section 403(b) contracts subject to the distribution rules provided in section 401(a)(9)?

A-1. (a) Yes. Section 403(b) contracts are subject to the distribution rules provided in section 401(a)(9). For purposes of this section the term section 403(b) contract means an annuity contract described in section 403(b)(1), custodial account described in section 403(b)(7), or a retirement income account described in section 403(b)(9). (b) For purposes of applying the distribution rules in section 401(a)(9), section 403(b) contracts will be treated as individual retirement annuities described in section 408(b) and individual retirement accounts described in section 408(a)(16). Consequently, except as otherwise provided in paragraph (c), the distribution rules in section 401(a)(9) will be applied to section 403(b) contracts in accordance with the provisions in § 1.408-8.

(c)1. The required beginning date for purposes of section 403(b)(9) is April 1, of the calendar year following the later of the calendar year in which the employee attains 70½ or the calendar year in which the employee retires from employment with the employer maintaining the plan. The concept of 5-percent owner has no application in the case of employees described in section 403(b)(1)(A).
(2) The rule in A-5 of § 1.408-8 does not apply to section 403(b) contracts. Thus, the surviving spouse of an employee is not permitted to treat a section 403(b) contract of which the spouse is the sole beneficiary as the spouse's own section 403(b) contract.

Q-2. To what benefits under section 403(b) contracts, do the distribution rules provided in section 401(a)(9) apply?

A-2. (a) The distribution rules provided in section 401(a)(9) apply to all benefits under section 403(b) contracts accruing after December 31, 1986 (post-86 account balance). The distribution rules provided in section 401(a)(9) do not apply to the balance of the account balance under the section 403(b) contract valued as of December 31, 1986, exclusive of subsequent earnings (pre-87 account balance). Consequently, the post-86 account balance includes earnings after December 31, 1986 on contributions made before January 1, 1987, in addition to the contributions made after December 31, 1986 and earnings thereon. The issuer or custodian of the section 403(b) contract must keep records that enable it to identify the pre-87 account balance and subsequent changes as set forth in paragraphs (b) of this A-2 and provide such information upon request to the relevant employee or beneficiaries with respect to the contract. If the issuer does not keep such records, the entire account balance will be treated as subject to section 401(a)(9).

(b) In applying the distribution rules in section 401(a)(9), only the post-86 account balance is used to calculate the required minimum distribution required for a calendar year. The amount of any distribution required to satisfy the required minimum distribution requirement for a calendar year will be treated as being paid from the post-86 account balance. Any amount distributed in a calendar year in excess of the required minimum distribution requirement for a calendar year will be treated as paid from the pre-87 account balance. The pre-87 account balance for the next calendar year will be permanently reduced by the deemed distributions from the account.

(c) The pre-87 account balance and the post-87 account balance have no relevance for purposes of determining the amount includable in income under section 72.

Q-3. Must the value of the account balance under a section 403(b) contract as of December 31, 1986 be distributed in accordance with the minimum distribution incidental benefit requirement?

A-3. Distributions of the entire account balance of a section 403(b) contract, including the value of the account balance under the contract or account as of December 31, 1986, must satisfy the minimum distribution incidental benefit requirement. However, distributions attributable to the value of the account balance under the contract or account as of December 31, 1986 is treated as satisfying the minimum distribution incidental benefit requirement if such distributions satisfy the rules in effect as of July 27, 1987, interpreting 1.401-1(b)(1)(i).

Q-4. Is the required minimum distribution from one section 403(b) contract available for distribution before the distribution related to another section 403(b) contract in order to satisfy section 401(a)(9)?

A-4. Yes. The required minimum distribution must be separately determined for each section 403(b) contract of an employee. However, such amounts may then be totaled and the total distribution taken from any one or more of the individual section 403(b) contracts. However, under this rule, only amounts in section 403(b) contracts that an individual holds as an employee may be aggregated. Amounts in section 403(b) contracts that an individual holds as a beneficiary of the same decedent may be aggregated, but such amounts may not be aggregated with amounts held in section 403(b) contracts that the individual holds as the employee or as the beneficiary of another decedent. Distributions from section 403(b) contracts or accounts will not satisfy the distribution requirements from IRAs, nor will distributions from IRAs satisfy the distribution requirements from section 403(b) contracts or accounts.

Par. 5. Section § 1.408-8 is added to read as follows:

§ 1.408-8 Distributions requirements for individual retirement plans.

The following questions and answers relate to the distribution rules for IRAs provided in sections 406(a)(6) and 408(b)(3).

Q-1. Are individual retirement plans (IRAs) subject to the distribution rules provided in section 401(a)(9) and §§ 1.401(a)(9)–1 through 1.401(a)(9)–8 for qualified plans?

A-1. (a) Yes. Except as otherwise provided in this section, IRAs are subject to the required minimum distribution rules provided in section 401(a)(9) and §§ 1.401(a)(9)–1 through 1.401(a)(9)–8 for qualified plans. For example, whether the five year rule or the life expectancy rule applies to distribution after death occurring before the IRA owner's required beginning date will be determined in accordance with § 1.401(a)(9)–3, the rules of § 1.401(a)(9)–4 apply for purposes of determining an IRA owner's designated beneficiary, the amount of the required minimum distribution required for each calendar year from an individual account will be determined in accordance with § 1.401(a)(9)–5, and whether annuity payments from an individual retirement annuity satisfy section 401(a)(9) will be determined under § 1.401(a)(9)–6. For purposes of the term IRA means an individual retirement account or annuity described in section 408(a) or (b).

(b) For purposes of applying the required minimum distribution rules in §§ 1.401(a)(9)–1 through 1.401(a)(9)–8 for qualified plans, the IRA trustee, custodian, or issuer is treated as the plan administrator, and the IRA owner is substituted for the employee.

Q-2. Are employer contributions under a simplified employee pension (defined in section 408(k)) or a SIMPLE IRA (defined in section 408(p)) treated as contributions to an IRA?

A-2. Yes. IRAs that receive employer contributions under a simplified employee pension (defined in section 408(k)) or a SIMPLE IRA (defined in section 408(p)) are treated as IRAs for purposes of section 401(a) and are, therefore, subject to the distribution rules in this section.

Q-3. In the case of distributions from an IRA, what does the term required beginning date mean?

A-3. In the case of distributions from an IRA, the term required beginning date means April 1 of the calendar year following the calendar year in which the individual attains age 70½.

Q-4. When is the amount of a distribution from an IRA not eligible for rollover because the amount is a required minimum distribution?

A-4. The amount of a distribution that is a required minimum distribution from an IRA and thus not eligible for rollover because the amount is a required minimum distribution?

Q-5. Must the account balance under section 401(a)(9) be treated for purposes of determining the amount includable in income under section 72?
Q-5. May an individual's surviving spouse elect to treat such spouse's entire interest as a beneficiary in an individual's IRA, upon the death of the individual (or the remaining part of such interest if distribution to the spouse has commenced) as the spouse's own account?

A-5. (a) The surviving spouse of an individual may elect in the manner described in paragraph (b) of this A-5 to treat the spouse's entire interest as a beneficiary in an individual's IRA (or the remaining part of such interest if distribution thereof has commenced to the spouse) as the spouse's own IRA. This election is permitted to be made at any time after the distribution of the required minimum amount for the account for the calendar year containing the individual's date of death. In order to qualify the surviving spouse as the sole beneficiary of the IRA and have an unlimited right to withdrawal amounts from the IRA, this requirement is not satisfied if a trust is named as the beneficiary of the IRA even if the spouse is the sole beneficiary of the trust. If the surviving spouse makes such an election, the surviving spouse's interest in the IRA would then be subject to the distribution requirements of section 401(a)(9)(A) applicable to the spouse as the IRA owner rather than those of section 401(a)(9)(B) applicable to the surviving spouse as the decedent IRA owner's beneficiary. Thus, the required minimum distribution for the year of the election and each subsequent year would be determined under section 401(a)(9)(A) with the spouse as IRA owner and not section 401(a)(9)(B).

(b) The election described in paragraph (a) of this A-5 is made by the surviving spouse redesignating the account as the account in the name of the surviving spouse as IRA owner rather than as beneficiary. Alternatively, a surviving spouse eligible to make the election is deemed to have made the election if, at any time, either of the following occurs:

(1) Any required amounts in the account (including any amounts that have been rolled over or transferred, in accordance with the requirements of section 404(d)(3)(A)(ii)), into an individual retirement account or individual retirement annuity for the benefit of such surviving spouse have not been distributed within the appropriate time period applicable to the surviving spouse as beneficiary under section 401(a)(9)(B); or

(2) Any additional amounts are contributed to the account (or to the account or annuity to which the surviving spouse has rolled such amounts over, as described in (1) above) which are subject, or deemed to be subject, to the distribution requirements of section 401(a)(9)(A).

(c) The result of an election described in paragraph (b) of this A-5 is that the surviving spouse shall then be considered the IRA owner for whose benefit the trust is maintained for all purposes under the Code (e.g. section 72(t)).

Q-6. How is the benefit determined for purposes of calculating the required minimum distribution from an IRA?

A-6. For purposes of determining the required minimum distribution required to be made from an IRA in any calendar year, the account balance of the IRA as of the December 31 of the calendar year immediately preceding the calendar year for which distributions are being made will be substituted in A-3 of § 1.401(a)(9)-5 for the account of the employee. The account balance as of December 31 of such calendar year is the value of the IRA upon close of business on such December 31. However, for purposes of determining the required minimum distribution for the second distribution calendar year for an individual, the account balance as of December 31 of such calendar year must be reduced by any distribution (as described in A-3(c)(2) of § 1.401(a)(9)-5) made to satisfy the required minimum distribution requirements for the individual's first distribution calendar year after such date.

Q-7. What rules apply in the case of a rollover to an IRA of an amount distributed by a qualified plan or another IRA?

A-7. If the surviving spouse of an employee rolls over a distribution from a qualified plan, such surviving spouse may elect to treat the IRA as the spouse's own IRA in accordance with the provisions in A-5 of this section. In the event of any other rollover to an IRA of an amount distributed by a qualified plan or another IRA, the rules in § 1.401(a)(9)-3 will apply for purposes of determining the account balance for the receiving IRA and the required minimum distribution from the receiving IRA. However, because the value of the account balance is determined as of December 31 of the year preceding the year for which the required minimum distribution is being determined and not as of a valuation date in the preceding year, the account balance of the receiving IRA need not be adjusted for the amount received as provided in A-2 of § 1.401(a)(9)-7 in order to determine the required minimum distribution for the calendar year following the calendar year in which the amount rolled over is received, unless the amount received is deemed to have been received in the immediately preceding year, pursuant to A-2 of § 1.401(a)(9)-7. In that case, for purposes of determining the required minimum distribution for the calendar year in which such amount is actually received, the account balance of the receiving IRA as of December 31 of the preceding year must be adjusted by the amount received in accordance with A-2 of § 1.401(a)(9)-7.

Q-8. What rules apply in the case of a transfer from one IRA to another IRA?

A-8. In the case of a transfer from one IRA to another IRA, the rules in A-3 or A-4 of § 1.401(a)(9)-7 will apply for purposes of determining the account balance of, and the required minimum distribution from, the IRAs involved. Thus, the transferor IRA must distribute in the year of the transfer any amount required determined with regard to the transfer. For purposes of determining the account balance of the transferor IRA and the transferor IRA, the account balance need not be adjusted for the amount transferred as provided in A-4(a) of § 1.401(a)(9)-7 in order to calculate the required minimum distribution for the calendar year following the calendar year for which the required minimum distribution is being determined.

Q-9. Is the required minimum distribution from one IRA of an owner permitted to be distributed to another IRA in order to satisfy section 401(a)(9)?

A-9. Yes. The required minimum distribution must be calculated separately for each IRA. However, such amounts may then be totaled and the total distribution taken from any one or more of the individual IRAs. However, under this rule, only amounts in IRAs that an individual holds as the IRA owner may be aggregated. Amounts in IRAs that an individual holds as a beneficiary of the same decedent may be aggregated, but such amounts may not be aggregated with amounts held in IRAs that the individual holds as the IRA owner or as the beneficiary of another decedent. Distributions from section 403(b) contracts or accounts will not satisfy the distribution requirements from IRAs, nor will distributions from IRAs satisfy the distribution requirements from section 403(b) contracts or accounts. Distributions from Roth IRAs (defined in section 408A) will not satisfy the distribution requirements applicable to IRAs or section 403(b) contracts or accounts and distributions from IRAs or section 403(b) contracts or accounts will not
satisfy the distribution requirements from Roth IRAs.

Q-10. Is the trustee of an IRA required to report the amount that is required to be distributed from that IRA?

A-10. Yes. The trustee of an IRA is required to report to the Internal Revenue Service and to the IRA owner the amount required to be distributed from the IRA for each calendar year at the time and in the manner prescribed in the instructions to the applicable Federal tax forms, as well as any additional information as required by such forms or such instructions.

PART 54—PENSION EXCISE TAXES

Par. 6. The authority citation for part 54 is amended by adding the following citation to read as follows:

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

§54.4974-2 is also issued under 26 U.S.C. 4974.

Par. 7. Section after §54.4974-2 is added to read as follows:

§54.4974-2 Excise tax on accumulations in qualified retirement plans.

Q-1. Is any tax imposed on a payee under any qualified retirement plan or any eligible deferred compensation plan (as defined in section 457(b)) to whom an amount is required to be distributed for a taxable year if the amount distributed during the taxable year is less than the required minimum distribution?

A-1. Yes. If the amount distributed to a payee under any qualified retirement plan or any eligible deferred compensation plan (as defined in section 457(b)) for a calendar year is less than the required minimum distribution for such year, an excise tax is imposed on such payee under section 4974 for the taxable year beginning with or within the calendar year during which the amount is required to be distributed. The tax is equal to 50 percent of the amount by which such required minimum distribution exceeds the actual amount distributed during the calendar year. Section 4974 provides that this tax shall be paid by the payee. For purposes of section 4974, the term required minimum distribution means the required minimum distribution amount required to be distributed pursuant to section 401(a)(9), 403(b)(10), 408(a)(6), 408(b)(3), or 457(d), as the case may be, and the regulations thereunder. Except as otherwise provided in Q&A-6, the required minimum distribution for a calendar year is the required minimum distribution amount required to be distributed during the calendar year. Q&A-6 provides a special rule for amounts required to be distributed by an employee’s (or individual’s) required beginning date.

Q-2. For purposes of section 4974, what is a qualified retirement plan?

A-2. For purposes of section 4974, each of the following is a qualified retirement plan—

(a) A plan described in section 401(a) which includes a trust exempt from tax under section 501(a); or

(b) An annuity plan described in section 403(a);

(c) An annuity contract, custodial account, or retirement income account described in section 403(b);

(d) An individual retirement account described in section 408(a); or

(e) An individual retirement annuity described in section 408(b); or

(f) Any other plan, contract, account, or annuity that, at any time, has been treated as a plan, account, or annuity described in (a) through (e) of this A-2, whether or not such plan, contract, account, or annuity currently satisfies the applicable requirements for such treatment.

Q-3. If a payee’s interest under a qualified retirement plan is in the form of an individual account and the required minimum distribution for a given calendar year determined for purposes of section 4974?

A-3. (a) General rule. If a payee’s interest under a qualified retirement plan is in the form of an individual account and distribution of such account is not being made under an annuity contract purchased in accordance with A-4 of §1.401(a)(9)-6, the amount of the required minimum distribution for any calendar year for purposes of section 4974 is the required minimum distribution amount required to be distributed for such calendar year in order to satisfy the required minimum distribution requirements in §1.401(a)(9)-5 as provided in the following (whichever is applicable)—

(1) Section 401(a)(9) and §§1.401(a)(9)-1 through 1.401(a)(9)-8 in the case of a plan described in section 401(a) which includes a trust exempt under section 501(a) or an annuity plan described in section 403(a);

(2) Section 403(b)(10) and §1.403(b)-2 in the case of an annuity contract, custodial account, or retirement income account described in section 403(b); or

(3) Section 408(a)(6) or (b)(3) and §1.408-8 in the case of an individual retirement account or annuity described in section 408(a) or (b).

(b) Default provisions. Unless otherwise provided under the qualified retirement plan (or, if applicable, the governing instrument of the qualified retirement plan), the default provisions in A-4(a) of §1.401(a)(9)-3 apply in determining the required minimum distribution for purposes of section 4974.

(c) Five year rule. If the five-year rule in section 401(a)(9)(B)(ii) applies to the distribution to a payee, no amount is required to be distributed for any calendar year to satisfy the applicable enumerated section in paragraph (a) of this A-3 until the calendar year which contains the date five years after the date of the employee’s death. For the calendar year which contains the date five years after the employee’s death, the required minimum distribution amount required to be distributed to satisfy the applicable enumerated section is the payee’s entire remaining interest in the qualified retirement plan.

Q-4. If a payee’s interest in a qualified retirement plan is being distributed in the form of an annuity (either directly from the plan, in the case of a defined benefit plan, or under an annuity contract purchased from an insurance company), the amount of the required minimum distribution determined for purposes of section 4974?

A-4. If a payee’s interest in a qualified retirement plan is being distributed in the form of an annuity (either directly from the plan, in the case of a defined benefit plan, or under an annuity contract purchased from an insurance company), the amount of the required minimum distribution determined for purposes of section 4974 will be determined as follows:

(a) Permissible annuity distribution option. A permissible annuity distribution option is an annuity contract (or, in the case of annuity distributions from a defined benefit plan, a distribution option) which specifically provides for distributions which, if made as provided, would for every calendar year equal or exceed the required minimum distribution amount required to be distributed to satisfy the applicable section enumerated in paragraph (a) of A-2 of this section for every calendar year. If the annuity contract (or, in the case of annuity distributions from a defined benefit plan, a distribution option) under which distributions to the payee are being made is a permissible annuity distribution option, the required minimum distribution for a given calendar year will equal the amount which the annuity contract (or, distribution option) provides is to be distributed for that calendar year.

(b) Impermissible annuity distribution option. An impermissible annuity distribution option is an annuity contract (or, in the case of annuity distributions from a defined benefit plan, a distribution option) under which distributions to the payee are being made that specifically provides for
distributions which, if made as provided, would for any calendar year be less than the required minimum distribution amount required to be distributed to satisfy the applicable section enumerated in paragraph (a) of A–2 of this section. If the annuity contract (or, in the case of annuity distributions from a defined benefit plan, the annuity option) the required minimum distribution amount required to be distributed to the payee is being made is an impermissible annuity distribution option, the required minimum distribution amount required to be distributed for each calendar year will be determined as follows:

(1) If the qualified retirement plan under which distributions are being made is a defined benefit plan, the amount required to be distributed each year will be the amount which would have been distributed under the plan if the distribution option under which the distributions to the payee were being made was the following permissible annuity distribution option:

(i) In the case of distributions commencing before the death of the employee, if there is a designated beneficiary under the impermissible annuity distribution option for purposes of section 401(a)(9), the permissible annuity distribution option is the joint and survivor annuity option under the plan for the lives of the employee and the designated beneficiary which provides for the greatest level amount payable to the employee or designated beneficiary on an annual basis. If the plan does not provide such an option or there is no designated beneficiary under the impermissible annuity distribution option for purposes of section 401(a)(9), the permissible annuity distribution option is the life annuity option under the plan payable for the life of the employee in level amounts with no survivor benefit.

(ii) In the case of distributions commencing after the death of the employee, if there is a designated beneficiary under the impermissible annuity distribution option for purposes of section 401(a)(9), the permissible annuity distribution option is the life annuity option under the plan payable for the life of the designated beneficiary in level amounts. If there is no designated beneficiary, the five-year rule in section 401(a)(9)(B)(ii) applies. See paragraph (b)(3) of this A–4. The determination of whether or not there is a designated beneficiary, and the determination of which designated beneficiary’s life is to be used in the case of multiple beneficiaries will be made in accordance with § 1.401(a)(9)-4 and A–7 of § 1.401(a)(9)-5. If the defined benefit plan does not provide for distribution in the form of the applicable permissible distribution option, the required minimum distribution for each calendar year will be an amount as determined by the Commissioner.

(2) If the qualified retirement plan under which distributions are being made is a defined contribution plan and the impermissible annuity distribution option is an annuity contract purchased from an insurance company, the required minimum distribution amount required to be distributed each year will have been distributed in the form of an annuity contract under the permissible annuity distribution option under the plan determined in accordance with a permissible annuity distribution option for defined benefit plans. If the defined contribution plan does not provide the applicable permissible annuity distribution option, the required minimum distribution for each calendar year will be the amount which would have been distributed under an annuity described below in paragraph (b)(2)(i) or (ii) of this A–4 purchased with the employee’s or individual’s account used to purchase the annuity contract which is the impermissible annuity distribution option.

(i) In the case of distributions commencing before the death of the employee, if there is a designated beneficiary under the impermissible annuity distribution option for purposes of section 401(a)(9), the annuity is a joint and survivor annuity for the lives of the employee and the designated beneficiary which provides level annual payments and which would have been payable to the payee under the annuity contract which is the impermissible annuity distribution option. However, the amount of the periodic payment which would have been payable to the survivor will be the applicable percentage under the table A–2(b) of § 1.401(a)(9)-6 of the amount of the periodic payment which would have been payable to the employee or individual. If there is no designated beneficiary under the impermissible annuity distribution option for purposes of section 401(a)(9), the annuity is a life annuity for the life of the employee with no survivor benefit which provides level annual payments and which would have been a permissible annuity distribution option.

(ii) In the case of a distribution commencing after the death of the employee, if there is a designated beneficiary under the impermissible annuity distribution option for purposes of section 401(a)(9), the annuity option is a life annuity for the life of the designated beneficiary which provides level annual payments and which would have been permissible annuity distribution option. If there is no designated beneficiary, the five-year rule in section 401(a)(9)(B)(ii) applies. See paragraph (b)(3) of this A–4. The determination of whether or not there is a designated beneficiary and the determination of which designated beneficiary’s life is to be used in the case of multiple beneficiaries will be made in accordance with § 1.401(a)(9)-4 and A–7 of § 1.401(a)(9)-5. If the defined benefit plan does not provide for distribution in the form of the applicable permissible distribution option, the required minimum distribution for each calendar year will be an amount as determined by the Commissioner.

If the five-year rule in section 401(a)(9)(B)(ii) applies to the distribution to the payee under the contract (or distribution option), no amount is required to be distributed to satisfy the applicable enumerated section in paragraph (a) of this A–4 until the calendar year which contains the date five years after the date of the employee’s death. For the calendar year which contains the date five years after the employee’s death, the required minimum distribution amount required to be distributed to satisfy the applicable enumerated section is the payee’s entire remaining interest in the annuity contract (or under the plan in the case of distributions from a defined benefit plan).

Q–5. If there is any remaining benefit with respect to an employee (or IRA owner) after any calendar year in which the entire remaining benefit is required to be distributed under section, what is the amount of the minimum distribution for each calendar year subsequent to such calendar year?

A–5. If there is any remaining benefit with respect to an employee (or IRA owner) after the calendar year in which the entire remaining benefit is required to be distributed, the required minimum distribution for each calendar year is the entire remaining benefit.

Q–6. If a payee has an interest under an eligible deferred compensation plan (as defined in section 457(b)), how is the required minimum distribution for a given taxable year of the payee determined for purposes of section 4974?

A–6. If a payee has an interest under an eligible deferred compensation plan (as defined in section 457(b)), the required minimum distribution for a given taxable year of the payee
determined for purposes of section 4974 is determined under section 457(d).
Q-7. With respect to which calendar year is the excise tax under section 4974 imposed in the case in which the amount not distributed is an amount required to be distributed by April 1 of a calendar year (by the employee's or individual's required beginning date)?
A-7. In the case in which the amount not paid is an amount required to be paid by April 1 of a calendar year, such amount is a required minimum distribution for the previous calendar year, i.e., for the employee's or the individual's first distribution calendar year. However, the excise tax under section 4974 is imposed for the calendar year containing the last day by which the amount is required to be distributed, i.e., the calendar year containing the employee's or individual's required beginning date, even though the preceding calendar year is the calendar year for which the amount is required to be distributed. Pursuant to A-2 of § 1-401(a)(9)-5, amounts distributed in the employee's or individual's first distribution calendar year will reduce the amount required to be distributed in the next calendar year by the employee's or individual's required beginning date. There is also a required minimum distribution for the calendar year which contains the employee's required beginning date. Such distribution is also required to be made during the calendar year which contains the employee's required beginning date.
Q-8. Are there any circumstances when the excise tax under section 4974 for a taxable year may be waived?
A-8. (a) Reasonable cause. The tax under section 4974(a) may be waived if the payee described in section 4974(a) establishes to the satisfaction of the Commissioner the following—
1. The shortfall described in section 4974(a) in the amount distributed in any taxable year was due to reasonable error; and
2. Reasonable steps are being taken to remedy the shortfall.
(b) Automatic Waiver. The tax under section 4974 will be automatically waived, unless the Commissioner determines otherwise, if—
1. The payee described in section 4974(a) is an individual who is the sole beneficiary and whose required minimum distribution amount for a calendar year is determined under the life expectancy rule described in § 1.401(a)(9)-3 A-3 in the case of an employee's death before the employee's required beginning date; and
2. The employee's or individual's entire benefit to which that beneficiary is entitled is distributed by the end of the fifth calendar year following the calendar year that contains the employee's date of death.

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

[FR Doc. 01-304 Filed 1-12-01; 8:45 am]
BILLING CODE 4830-01-P
July 3, 2001

Mr. and Mrs. Harold Benson
1222 Osius Street
Adell, WI

Re: Your IRAs and the Inherited IRA Strategy

Dear Harold and Amanda:

I think that you should consider adopting a strategy that would allow the large balance in your IRAs to be inherited intact by your children at the time the surviving spouse dies. The key advantage of this strategy is that it allows your children to keep the qualified assets in an income tax-deferred environment (an inherited IRA) and to take withdrawals from the inherited IRA over their own life expectancies. Through proper planning, which requires the execution of documents and providing funding for the strategy, you can create substantial wealth transfer opportunities for your family.

Ordinarily, an IRA distribution strategy that provides the greatest benefit to your family is one that provides the greatest possible tax deferral. By delaying withdrawals from the IRA as long as possible, the amount of wealth that can be transferred is maximized. There is one exception, however, to this general rule. The exception comes into play when funds are withdrawn from an
IRA to purchase life insurance that will permit the IRA to remain *intact* beyond the surviving spouse’s death. The insurance proceeds will provide the necessary liquidity to pay any estate taxes due following the death of the surviving spouse.

Typically, at the death of the first spouse to die, the surviving spouse rolls over the IRA assets into a rollover IRA. When this step is taken, any estate taxes are deferred until the death of the surviving spouse. At the surviving spouse’s death, estate tax is due on the total taxable estate and the tax must be paid within nine months of the death. Unless the estate tax can be paid from sources other than the IRA, the IRA will have to be *invaded* to pay the tax. If it is necessary to invade, the opportunity for tax deferral on the funds invested in the IRA comes to an end.

When funds have to be withdrawn from an IRA to pay an estate tax liability, those withdrawn funds become subject to income tax. This results in the so-called *negative tax spiral* and could ultimately result in a total tax loss of up to 60 to 70 percent of the original IRA balance. Here are some numbers that will show you this massive tax erosion, which leaves only 30 to 40 percent of the IRA to your heirs.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance in your IRA</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Less: Projected Estate Tax</td>
<td>(945,000)</td>
</tr>
<tr>
<td>Projected Income Tax</td>
<td>(378,721)</td>
</tr>
<tr>
<td>Net to Heirs</td>
<td>$676,279</td>
</tr>
<tr>
<td>Percentage to Heirs</td>
<td>34 percent</td>
</tr>
<tr>
<td>Percentage to Taxes</td>
<td>66 percent</td>
</tr>
</tbody>
</table>
To prevent this devastating depletion of wealth, the funds to pay the taxes must come from sources outside of the IRA. It is possible, when we review your personal balance sheet, that you may have enough liquid assets available to pay any projected estate taxes due. But because your IRAs represent such a large portion of your estate, you should consider the strategy of buying life insurance to provide the necessary liquidity.

Generally this strategy is implemented by establishing an irrevocable life insurance trust with your family as beneficiaries. Once the trust is created, you would make gifts of cash to the trust. The trustees would then use the cash to purchase a survivorship life insurance policy covering both of you. Then at the second death, when the trust receives the life insurance proceeds, those funds are used to purchase estate assets (usually nonliquid assets) or are loaned to the estate. An alternative to consider is to distribute trust assets directly to the beneficiaries so they can pay the estate tax. Whichever way you might choose to proceed, you have provided the funds to pay any estate tax liability while at the same time eliminating the need to invade the IRA.

In a related step, your heirs can begin to receive distributions from the IRA over their life expectancies following the second death. (There are special rules for determining the amount of the distributions to the heirs related to the life expectancy of the oldest beneficiary—the beneficiary with the shortest life expectancy.)
I think that this strategy deserves to be considered as part of your retirement and estate planning.

I will call in a few days to answer any questions you have about putting the strategy outlined above to work for you and your family.

With kindest personal regards.

Sincerely,

Robert S. Keebler, CPA, MST