[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9220]

RIN 1545-BE66

Converting an IRA Annuity to a Roth IRA

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary Regulations.

SUMMARY: This document contains temporary regulations under section 408A of the Internal Revenue Code (Code). These temporary regulations provide guidance concerning the tax consequences of converting a non-Roth IRA annuity to a Roth IRA. These temporary regulations affect individuals establishing Roth IRAs, beneficiaries under Roth IRAs, and trustees, custodians and issuers of Roth IRAs. The text of these temporary regulations also serves as the text of proposed regulations set forth in a notice of proposed rulemaking in the Proposed Rules section of this issue of the **Federal Register**.

DATES: Effective Date: These regulations are effective August 19, 2005.

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

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Cathy A. Vohs, 202-622-6060.

SUPPLEMENTARY INFORMATION:

Background

Roth IRAs and Conversions

This document contains temporary regulations that amend the Income Tax Regulations (26 CFR part 1) under section 408A of Code relating to Roth IRAs. Section 408A of the Code, which was added by section 302 of the Taxpayer Relief Act of 1997, Public Law 105-34 (111 Stat. 788), establishes the Roth IRA as a type of individual retirement plan, effective for taxable years beginning on or after January 1, 1998.

Under Code section 408A, a Roth IRA is treated like a traditional IRA with several significant exceptions. Like amounts held in traditional IRAs, amounts held in Roth IRAs generally are exempt from Federal income tax under Code section 408(e)(1). Likewise, contributions to traditional IRAs and Roth IRAs are subject to specific limitations.

The identifying characteristic of Roth IRAs is that all contributions are after-tax contributions, and qualified distributions are tax free. Thus, unlike certain contributions to traditional IRAs, which may be deductible, contributions to Roth IRAs cannot be deducted from gross income. Distributions from a traditional IRA are includable in gross income except to the extent attributable to a return of basis. However, qualified distributions from Roth IRAs are excludable from gross income. Under section 408A(d)(2), a qualified distribution from a Roth IRA is a distribution that is made: (1) at least 5 years after the account owner (or the account owner's spouse) made a Roth IRA contribution, and (2) after age 59 ½, after death, on account of disability, or for a first-time home purchase.

A taxpayer whose modified adjusted gross income for a year does not exceed

$100,000 may convert an amount held in a non-Roth IRA (i.e., a traditional IRA or SIMPLE IRA) to an amount held in a Roth IRA. This conversion requires taking into income the value of the non-Roth IRA being converted (to the extent the conversion is not a conversion of basis in the non-Roth IRA), essentially converting the value into an after-tax rollover contribution to the Roth IRA. A conversion may be accomplished by means of a rollover, trustee-to-trustee transfer, or account redesignation.

Regardless of the means used to convert, any amount converted from a non-Roth IRA to a Roth IRA is treated as distributed from the non-Roth IRA and rolled over to the Roth IRA. The conversion amount is generally includible in gross income for the year of the conversion under section 408(d)(1) and (2). In the case of a conversion involving property, the conversion amount generally is the fair market value of the property on the date of distribution or the date the property is treated as distributed from the traditional IRA.

Final regulations regarding Roth IRAs were published in the **Federal Register** on February 4, 1999 (64 FR 5597). Section 1.408A-4 provides rules relating to converting amounts from a traditional IRA to a Roth IRA. Section 1.408A-4, A-7, which sets forth the tax consequences of converting an amount held in a traditional IRA to a Roth IRA, provides that any amount that is converted to a Roth IRA is includible 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.

Under A-1 of §1.408A-7, any amount converted from a non-Roth IRA to a Roth IRA is treated as a distribution for which a Form 1099-R, "Distributions From Pensions,

Annuities, Retirement or Profit-Sharing Plans, IRA, Insurance Contracts," must be filed by the trustee maintaining the non-Roth IRA.

Fair Market Value of Annuity Contracts

Before the enactment of section 408A, the need to value an annuity contract as a result of distribution from a qualified plan or IRA rarely arose. The distribution of an annuity contract from a qualified plan or a traditional IRA is generally not a taxable event because, in most cases, the distributed annuity account contract continues to be subject to requirements necessary for tax deferral, e.g., the annuity remains subject to the minimum distribution requirements of section 401(a)(9). In such a case, no amount is includible in income until amounts are actually distributed from the annuity contract. However, in certain situations, the Code provides that the fair market value of an individual retirement annuity is treated as a taxable distribution. For example, under section 408(e), the fair market value of the annuity is included in taxable income if the annuity ceases to be an individual retirement annuity because of violations of requirements set forth under that subsection.

Section 25.2512-6 of the Gift Tax Regulations provides rules regarding the valuation of certain life insurance contracts for gift tax purposes[1]. Under these rules, the value of a life insurance contract or of a contract for the payment of an annuity issued by a company regularly engaged in the selling of contracts of that character is established

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1 In Rev. Rul. 59-195 (1959 -1 C.B. 18), the IRS ruled that, in situations similar to those in which an employer purchases and pays the premiums on an insurance policy on the life of one of its employees and subsequently sells such policy, on which further premiums must be paid, the value of such policy for computing taxable gain in the year of purchase should be determined under the method of valuation prescribed in §25.2512-6 of the Gift

through the sale of the particular contract by the company, or through the sale by the company of comparable contracts. In addition, §25.2512-6 provides that, as the value of an insurance policy through sale of comparable contracts is not readily ascertainable when the gift is of a contract which has been in force for some time and on which further premium payments are to be made, the value may be approximated by adding to the interpolated terminal reserve at the date of the gift the proportionate part of the gross premium last paid before the date of the gift which covers the period extending beyond that date. If, however, because of the unusual nature of the contract, such approximation is not reasonably close to the full value, this method may not be used. Thus, this method may not be used to determine the fair market value of an insurance policy where the reserve does not reflect the value of all relevant features of the policy. These gift tax valuation rules also apply for purposes of commercial annuity contracts. See Examples 1 and 2 of §25.2512-6. In addition, under §20.2031-8 of the Estate Tax Regulations, the same rules govern the valuation of such life insurance and commercial annuity contracts for estate tax purposes. See §§20.2031-7(b) and 20.2039-1(c).

Under A-12 of §1.401(a)(9)-6, an employee's entire interest under an annuity contract is the dollar amount credited to the employee or beneficiary under the contract plus the actuarial value of any additional benefits (such as survivor benefits in excess of the account balance) that will be provided under the contract. This rule requiring that the value of additional benefits under an annuity contract be included in the employee's entire interest, for purposes of determining the required minimum distribution under section

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Tax Regulations.

401(a)(9), is based on the general requirement that the fair market value of all assets must be reflected in valuing an account balance under a defined contribution plan. However, certain additional benefits may be disregarded for purposes of calculating the required minimum distribution, such as when there is a pro-rata reduction in additional benefits for a withdrawal and a guaranteed return of premiums upon death, to reflect the fact that distributions are being made to satisfy section 401(a)(9).

Rev. Proc. 2005-25 (2005-17 I.R.B. 962), provides safe harbor formulas that, if used to determine the value of a life insurance contact, retirement income contract, endowment contract, or other contract providing life insurance protection that is distributed or otherwise transferred from a qualified plan, will meet the definition of fair market value for purposes of applying the rules of section 402(a) (as well as sections 79, 83, and 402(b)).

Explanation of Provisions

These temporary regulations under section 408A clarify that, when a non-Roth individual retirement annuity is converted to a Roth IRA, the amount that is treated as distributed is the fair market value of the annuity contract on the date the annuity contract is converted. Similarly, when a non-Roth individual retirement account holds an annuity contract as an account asset and the account is converted to a Roth IRA, the amount that is treated as distributed with respect to the annuity contract is the fair market value of the annuity contract on the date the annuity contract is distributed or treated as distributed from the non-Roth IRA.

Some taxpayers and their advisers assert that the only amount includible in

income as a distribution when a non-Roth individual retirement annuity is converted to a Roth IRA is the cash surrender value of the contract, even when the cash surrender value does not accurately reflect the fair market value of the contract. In particular, some advisers market a transaction in which taxpayers are encouraged to invest their non-Roth IRA funds in a single premium annuity contract with significant artificial penalties that apply in the first year (or years) of the contract if the annuity is surrendered, causing the annuity to have a low cash surrender value in the early years of the contract. Under this transaction, shortly after the annuity contract is purchased by the non-Roth IRA, the taxpayer converts the IRA to a Roth IRA. In such a case, the taxpayer asserts that the only amount includible in gross income as a result of the conversion is the low cash surrender value. This assertion is made even though the surrender penalties are unlikely to be paid because the taxpayers do not expect to surrender the contract during the early years. In this case, the taxpayers expect that the ultimate payments under the contract will be qualified distributions from the Roth IRA (i.e., tax-exempt), and thus, they also expect the artificially depressed cash surrender value to be the only amount ever includible in gross income.

In another situation, a taxpayer purchases a non-Roth individual retirement variable annuity with a guaranteed minimum death benefit equal to the highest account value ever attained under the contract, adjusted for withdrawals. If an amount is withdrawn from the contract, the death benefit is reduced dollar for dollar (rather than a pro-rata reduction) by the amount of the withdrawal. Prior to the date of conversion, the annuity has a death benefit far in excess of the account value and the taxpayer withdraws

from the IRA annuity all but a minimum account value that will keep the IRA annuity in force. Because the withdrawal reduces the guaranteed minimum death benefit on a dollar-for-dollar basis, the remaining death benefit will be significantly greater than the current account value, and accordingly, the current account value will not reflect the fair market value of the contract. For example, suppose such an individual retirement variable annuity has a guaranteed minimum death benefit of $200,000 with an account value of $100,000. The taxpayer withdraws $99,000 leaving a $1,000 account value and a $101,000 death benefit ($200,000 less $99,000)). The taxpayer then converts the IRA annuity into a Roth IRA and takes the position that the $1,000 account value is the conversion amount even though the account value does not reflect the fair market value of the additional $100,000 that will be paid upon the taxpayer's death. In this case, the taxpayer expects that the entire benefit payment of $101,000 will be a qualified distribution from the Roth IRA (i.e., tax-exempt), and thus, expects that the $1,000 account value on the date of conversion will be the only amount ever includible in gross income.

The IRS and Treasury Department have concluded that cash surrender value is not always an appropriate measure of fair market value with respect to non-Roth IRA annuities that are converted to Roth IRA annuities. Rather than use the cash surrender value as the basis for determining fair market value, these temporary regulations follow the gift tax regulations in providing that the fair market value of an individual retirement annuity is established by the premiums paid for such annuity if the conversion occurs soon after the annuity was purchased.

Under the temporary regulations, if the conversion occurs after the annuity contract has been in force for some time and no further premium payments are to be made, fair market value is determined through the sale by the company of comparable contracts. The temporary regulations further provide that, if the conversion occurs after the annuity contract has been in force for some time and future premium payments are to be made, fair market value is determined through an approximation that is based on the interpolated terminal reserve at the date of the conversion, plus the proportionate part of the gross premium last paid before the date of the conversion which covers the period extending beyond that date. However, if, because of the unusual nature of the contract, this approximation is not reasonably close to the full value, this method may not be used.

These temporary regulations also provide authority for the Commissioner to issue additional guidance regarding the fair market value of an individual retirement annuity, including formulas to be used for determining fair market value. The IRS and Treasury Department expect to issue additional guidance regarding the rules to be used in determining the fair market value of a non-Roth IRA annuity. It is anticipated that such guidance will be similar to the provisions of Rev. Proc. 2005-25 (2005-17 I.R.B. 962, April 25, 2005), except that the adjustment for potential surrender charges, to the extent permitted, will not exceed 9 percent. It is also anticipated that such guidance will provide that in determining fair market value, the value of all additional benefits (such as guaranteed minimum death benefits) under the contract must be taken into account. The IRS and Treasury Department request comments regarding this anticipated guidance. The IRS and Treasury Department also request comments regarding whether the method

used to calculate the fair market value of an annuity contract that is converted to a Roth IRA should also apply for purposes of the determining fair market value of an annuity contract under sections 408(e) and 401(a)(9). These comments may be submitted in conjunction with the comments submitted on the proposed regulations discussed below.

Proposed regulations regarding the determination of fair market value of an annuity contract are contained in the Proposed Rules section of the **Federal Register**. The preamble and text of these temporary regulations also serves as the preamble and text of the proposed regulations.

Effective Date

The temporary amendments to §1.408A-4 of the regulations are applicable to any Roth IRA conversion where an annuity contract is distributed or treated as distributed from a traditional IRA on or after August 19, 2005. No implication is intended concerning whether or not a rule to be adopted in these regulations is applicable law for taxable years ending before that date.

Special Analyses

It has been determined that these temporary 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 temporary regulations. For applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6), refer to the notice of proposed rulemaking published in the Proposed Rules section of this issue of the **Federal Register**. Pursuant to section 7805(f) of the Code, these temporary

regulations will be 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 these temporary regulations is Cathy A. Vohs of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury Department participated in the development of these regulations.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

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

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

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

Par. 2. Section 1.408A-4 is amended by adding, in numerical order, Q-14 and A-14, to read as follows:

§1.408A-4 Converting amounts to Roth IRAs.

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Q-14. [Reserved]. For further guidance, see §1.408A-4T, Q-14.

A-14. [Reserved]. For further guidance, see §1.408A-4T, A-14.

Par. 3. Section 1.408A-4T is added to read as follows:

§1. 408A-4T Converting amounts to Roth IRAs.

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Q-14. What is the amount that is includable in income as a distribution when a conversion involves an annuity contract?

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

(b) Determination of fair market value--(1) General rule. For purposes of this A-14, the fair market value of an individual retirement annuity issued by a company regularly engaged in the selling of contracts of that character generally is established as follows--

(A) If the conversion occurs soon after the contract was sold and there have been no material changes in market conditions, the fair market value of the contract is established through the sale of the particular contract by the company (i.e., the actual

premiums paid for such contract);

(B) If the conversion occurs after the contract has been in force for some time and no further premium payments are to be made, the fair market value of the contract is established through the sale by the company of comparable contracts;

(C) If the conversion occurs after the contract has been in force for some time and future premium payments are to be made, the fair market value of the contract is established through an approximation that is based on the interpolated terminal reserve at the date of the conversion, plus the proportionate part of the gross premium last paid before the date of the conversion which covers the period extending beyond that date. However, if, because of the unusual nature of the contract, this approximation is not reasonably close to the full value, this method may not be used. Thus, this method may not be used to determine the fair market value of an annuity contract where the reserve does not reflect the value of all relevant features of the contract.

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

(c) Effective date. The provisions of this A-14 are applicable to any conversion where an annuity contract is distributed or treated as distributed from a traditional IRA on or after August 19, 2005.

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

Deputy Commissioner for Services and Enforcement.
Mark E. Matthews

Approved: August 9, 2005

Acting Deputy Assistant Secretary for Tax Policy.
Eric Solomon