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INTERNAL REVENUE SERVICE
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MEMORANDUM FOR: Area Counsel
(Small Business/Self-Employed: Area 1)
Attention: Mary Hamilton

FROM: Chief, Qualified Plans (Employee Benefits)
Office of the Division Counsel/Associate Chief Counsel
(Tax Exempt and Government Entities Division)

SUBJECT: Roth IRA Conversions Significant Service Center Advice

This Significant Service Center Advice responds to your memorandum dated April 17, 2001, regarding an inquiry you received from the Taxpayer Advocate at the Andover Service Center.

ISSUES

Issue 1: Does a failed Roth IRA conversion result in a distribution from the traditional IRA, including the imposition of the additional tax on early distributions, and the imposition of a six percent excise tax on excess contributions to the Roth IRA?

Issue 2: Does the Taxpayer Advocate have any discretion to allow a taxpayer to recharacterize a failed Roth IRA conversion after the deadline for recharacterizing an IRA contribution?

Issue 3: How should the taxes and penalties attributable to a failed Roth IRA conversion be assessed and collected against a taxpayer?

BRIEF ANSWER

Issue 1: A failed Roth IRA conversion that is not recharacterized is treated as a regular distribution from the traditional IRA, including the imposition of the additional tax on early distributions unless an exception applies, and as a regular contribution to the Roth IRA that is subject to the excise tax on excess contributions to the extent the contribution exceeds the applicable Roth IRA contribution limits.

Issue 2: The Taxpayer Advocate does not have discretion to allow a taxpayer to recharacterize a failed Roth IRA conversion after the deadline for recharacterizing an IRA contribution. This is a substantive determination that is beyond the scope of the authority accorded to the Taxpayer Advocate.

Issue 3: Statutory deficiency procedures must be used.

FACTS

In 1998, the taxpayer attempted to convert his traditional IRA to a Roth IRA. The taxpayer believed that he was eligible to convert to a Roth IRA because his 1998 modified adjusted gross income (AGI) was less than $100,000. The taxpayer chose to include the income from the traditional IRA over a four year period. On April 15, 2000, the Service issued an underreporter notice to the taxpayer for his 1998 year with the result that the 1998 modified AGI exceeded $100,000. The taxpayer filed an amended return for 1998, seeking a refund of the taxes paid on the Roth IRA conversion because there was a failed conversion. The taxpayer stated that he could not take advantage of the opportunity to correct the failed conversion on or before the deadline of December 31, 1999, because he did not know of the increase to his AGI until April 15, 2000.

The Service informed the taxpayer that there was in fact a failed Roth IRA conversion, resulting in a distribution of the traditional IRA in 1998. The distribution from the traditional IRA was includible in the taxpayer's income for 1998. Further, the transaction must be treated as a contribution to the taxpayer's Roth IRA, and is subject to the 6% excise tax under Internal Revenue Code (I.R.C.) § 4973, to the extent that it exceeds the amount of the taxpayer's regular IRA contribution, up until the time it is withdrawn. Further, the taxpayer is subject to an additional 10% tax on early distributions under I.R.C. § 72(t) with respect to the distribution from the traditional IRA.

APPLICABLE LAW

I.R.C. § 408(d)(1) generally provides that, except as otherwise provided, any amount paid or distributed out of an IRA shall be included in gross income.

I.R.C. § 408(d)(3) is an exception from the general rule of inclusion in income for rollover contributions, and provides that in the case of rollovers from an IRA to a Roth IRA, there shall be included in gross income any amount which would be includible were it not part of a qualified rollover contribution. Unless the taxpayer elects otherwise, the amount required to be included in gross income such taxable year by reason of I.R.C. § 408A(d)(3)(A) for any distribution before January 1,

1999, shall be so included ratably over the 4-year taxable period beginning with such taxable year. See Treas. Reg. § 1.408A-4, Q & A 8.

I.R.C. § 408A(3)(B) generally provides that a taxpayer shall not be allowed to make a qualified rollover contribution to a Roth IRA from a traditional individual retirement plan during any taxable year if the taxpayer's modified AGI for the year of the contribution exceeds $100,000. See Treas. Reg. § 1.408A-4, Q & A 2.

Treas. Reg. § 1.408A-5 Q & A-1 allows an IRA owner to recharacterize (i.e., treat a contribution made to one type of IRA as made to a different type of IRA) certain IRA contributions (including conversion contributions) for a taxable year. If there is a failed conversion, a taxpayer may recharacterize amounts which he or she attempted to contribute to the Roth IRA as contributions to the traditional IRA. Treas. Reg. § 1.408A-4, Q & A 3.

Under Treas. Reg. § 1.408A-5 Q & A-6(b), generally, the election to recharacterize an IRA contribution and the trustee-to-trustee transfer of such contribution (including allocable net income) 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.

Under the provisions of Treas. Reg. § 301.9100-2(b), an individual who timely files his or her Federal Income Tax return has an automatic 6 month extension from the return due date (excluding extensions) to recharacterize an IRA contribution. See also Announcement 99-57, 1999-1 C.B. 1256. In addition, under Announcement 99-104, 1999-2 C.B. 555, an individual who timely filed his/her 1998 Federal Income Tax return had until December 31, 1999 to recharacterize a 1998 IRA contribution (including an amount converted from a traditional IRA to a Roth IRA in 1998).

Under Treas. Reg. § 301.9100-3, the Commissioner may grant an additional extension of time to recharacterize an IRA contribution. Pursuant to § 6.04 of Rev. Proc. 2001-4, 2001-1 I.R.B. 121, 131, a request for an extension of time to recharacterize an IRA contribution under Treas. Reg. § 301.9100-3 is considered a letter ruling request.

If a failed conversion contribution is not recharacterized, it will be treated as a regular Roth contribution, and thus, an excess contribution will be subject to the excise tax under I.R.C. § 4973 to the extent it exceeds the individual's regular contribution limit. Treas. Reg. § 1.408A-4, Q & A 3. In addition, 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). Id.

I.R.C. § 72(t) provides, in general, that if any taxpayer receives a distribution from a qualified retirement plan prior to attaining the age of 59 ½ , there shall be added to the tax an amount equal to 10% of such distribution. The penalty under this section is only applicable in certain specific circumstances, for example, if the taxpayer is under age 59 ½.

I.R.C. § 4973(a) provides that, in the case of excess contributions to an individual's retirement account, there is imposed for each taxable year a tax in an amount equal to 6% of the amount of the excess contributions[1] to such individual's accounts or annuities.

The Taxpayer Advocate Service has both statutory and delegated authorities. IRC § 7803(c)(2)(A)(i) provides that it is the function of the Office of the Taxpayer Advocate to assist taxpayers in resolving problems with the Service. IRC § 7811(a)(1) also authorizes the National Taxpayer Advocate to issue Taxpayer Assistance Orders (TAOs) if she determines that the taxpayer is suffering or about to suffer a significant hardship as a result of the manner in which the internal revenue laws are being administered or the taxpayer meets such other requirements as are set forth in regulations prescribed by the Secretary of the Treasury.

IRC § 7811(b) provides the terms of a TAO. Specifically, the TAO may require the IRS, within a specified time period, to (1) release property of the taxpayer levied upon, or (2) cease any action, take any action as permitted by law, or refrain from taking any action, with respect to the taxpayer under chapter 64, subchapter B of chapter 70, chapter 78, or any other provision of law which is specifically described by the National Taxpayer Advocate in the TAO.

IRC § 7801 provides to the Secretary of the Treasury the authority to administer and enforce the internal revenue laws. This authority has been delegated to the Commissioner of the Internal Revenue, and the Commissioner has delegated specific tax administration responsibilities to the various divisions and functions of the Service, including the National Taxpayer Advocate. The National Taxpayer Advocate, is delegated the authority to perform certain tax administration duties generally recognized as accounts management type of authority. See Delegation Order No. 267.

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[1] Excess contributions are defined, in general, as the excess amounts contributed to IRAs over the amount allowable as a deduction under I.R.C. § 219. See I.R.C. § 4973(b).

In general, I.R.C. § 6212(a) prohibits the assessment and collection of a deficiency until a notice of deficiency has been mailed to the taxpayer and until certain statutory steps have been taken.

I.R.C. § 6213 imposes certain restrictions on the assessment of deficiencies. Section 6213(g)(2) defines "mathematical or clerical error" and enumerates 13 exceptions to the general rule where deficiency procedures need not be used before assessment of the tax.[2] Two of the exceptions may be applicable in answering the above question.

Under I.R.C. § 6213(g)(2)(C), a mathematical error includes "an entry on a return of an item which is inconsistent with another entry of the same or another item on such return." According to its legislative history, subsection (g)(2)(C) is intended to encompass those cases where it is apparent which of the inconsistent entries is correct and which is incorrect. Summary assessment procedures cannot be used where it is not clear which of the inconsistent entries is the correct one. They are also not to be used where the Service is merely resolving an uncertainty against the taxpayer. See H.R. Rep. No. 658, 94th Cong., 1st Sess. 291-292, 1976-3 C.B. (Vol.2) 695, 983.

Under I.R.C. § 6213(g)(2)(E), a math error may also be "an entry on a return of a deduction or credit in an amount which exceeds a statutory limit imposed by subtitle A or B, or chapter 41, 42, 43, or 44, if such limit is expressed - (i) as a specified monetary amount, or (ii) as a percentage, ratio, or fraction, and if the items entering into the application of such limit appear on such return." An example of a math error under (g)(2)(E) would be an entry claiming the medical expense deduction under section 213 without meeting the 7.5%-of-adjusted-gross-income floor.

ANALYSIS

Taxpayers are permitted to convert IRAs to Roth IRAs. If that is done, the amount converted shall be included in gross income to the extent that a distribution from the traditional IRA would have been included in gross income if it were not part of a Roth IRA conversion. The taxable portion of the distribution is fully taxable in the year that it is distributed from the traditional IRA, unless the year of distribution was 1998. If the conversion was made in 1998, the taxpayer may report the income from the distribution over four years.

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[2] Subsection (M), the 13th applicable situation, was added on June 7, 2001, when President Bush signed the Economic Growth and Tax Relief Reconciliation Act of 2001 ("the Act"), Pub. L. No. 107-16, 115 Stat. 38.

Many taxpayers made Roth IRA conversions in 1998 despite the fact that they were not eligible to do so because their modified AGI for the 1998 taxable year was more than $100,000. However, taxpayers were allowed to recharacterize failed conversions for the 1998 taxable year until December 31, 1999. After December 31, 1998, a taxpayer wishing to recharacterize must obtain an extension of the deadline to recharacterize under the procedures of Treas. Reg. 301.9100-3. These procedures involve filing a request for a private letter ruling and paying the applicable user fee.

If a failed conversion is not recharacterized, the distribution from the traditional IRA is treated as a regular distribution from the traditional IRA and is subject to the 10 percent additional tax on early distributions (unless an exception applies). The amount the taxpayer attempted to convert is treated as a regular contribution to the Roth IRA and is subject to the 6 percent excise tax under I.R.C. section 4973 (to the extent it is an excess Roth IRA) until it is withdrawn from the Roth IRA.

Neither the authority granted to the National Taxpayer Advocate under IRC § 7803(c) to assist taxpayers in resolving their problems with the Service, nor the authority to issue TAOs under IRC § 7811, provide the Taxpayer Advocate Service with the discretion to allow a taxpayer to recharacterize a failed IRA conversion or provide an extension of time for recharacterizing a failed IRA conversion. The determination of whether the requirements for recharacterizing a failed IRA conversion have been met is substantive in nature and the National Taxpayer Advocate has not been granted the statutory authority to make merits determinations or change technical decisions. See Treasury regulation § 301.7811-1(c)(3). The National Taxpayer Advocate may have authority to make technical decisions in matters under her delegated authority, however, recharacterizing failed IRA conversions is not within the scope of currently delegated authorities.

In order to analyze how tax and penalties applicable to a failed conversion should be assessed and collected, it is helpful to look at specific examples of the exceptions to the rule that deficiency procedures must be used. In GCM 39019[3], dated August 3, 1983, the conclusion was reached that “the exception to the normal

[3] G.C.M. 39131, dated February 16, 1984, used the analysis in G.C.M. 39019 in reaching its conclusion that the math error procedures could not be used in assessing the amount of tax withheld on nonresident aliens under section 1441. G.C.M. 39738, dated June 1, 1988, used the analysis in G.C.M. 39019 in reaching the conclusion that the mathematical error procedures were applicable because failure to attach a Form 8396, Mortgage Interest Credit, where a mortgage interest credit amount was claimed on the Form 1040 is the precise situation in which section 6213(g)(2)(D) was intended to apply.

assessment procedures for mathematical or clerical errors in section 6213(b) may not be used to correct deductions for contributions to individual retirement accounts . . . claimed on the Form 1040 and to summarily assess additional tax . . . because the types of errors involved are not within the scope of the definition of mathematical or clerical errors in section 6213(g)(2)."

Some of the examples of errors not eligible for the mathematical error procedures were: (1) a deduction was claimed on line 25, Form 1040 for contributions to IRAs but no code was entered to identify the type and number of IRAs; (2) a code was entered but the deduction claimed exceeded the monetary amount of the statutory limit for the type and number of IRAs indicated by the code; (3) an excess contribution was made to the IRA based on the deduction claimed, but no excise tax was reported on line 57-Form 1040 and Form 5329 was not attached to the return.

In example (1), the GCM relied on the legislative history and concluded there was no math error because the error did not meet the definition of § 6213 (g)(2)(D). Subsection (g)(2)(D) defines a mathematical or clerical error as "an omission of information which is required to be supplied on the return to substantiate an entry on the return." The GCM reasoned that mathematical error procedures could not be used in example 1 because "omission of information" was construed to mean the omission of an entire schedule; the omission of a code is not the omission of an entire schedule.

In example (2), the GCM reasoned that there was no math error because the code that was entered did not cover all the possible variations on the types of IRA an individual might have. The GCM concluded that there was no math error under (g)(2)(E) because the monetary amount of the statutory limit varies according to which code is entered.[4] Although it could be argued that the discrepancy could fall under an "inconsistent entry" as defined in (g)(2)(C), the math error procedures still could not be used because the taxpayer may have entered the wrong code rather than claimed the wrong deduction. See S. Rep. No. 94-938, 94th Cong., 2d Sess. 377 (1976).

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[4] The maximum deduction that could be claimed by a married couple filing a joint return based on IRC § 219(b) for contributions to individual IRAs would be $4,000. However, theoretically, there is no limit on the number of employers who may contribute to SEPs on behalf of an individual and thus there is no limit on the amount of money an individual may deduct for employer contributions to his SEP. Consequently, because contributions to SEPs are included on line 25, there is no specific statutory limit on the deduction claimed on line 25 that may be determined without regard to the code entered.

In example (3), the GCM further concluded that math error procedures did not apply because the Service could not determine that the deduction exceeds the amount of compensation without determining what was compensation. Thus it would not be possible to determine whether an excess contribution was made. Even if it were possible to determine that an excess contribution had been made, the GCM concluded that the excise taxes imposed by sections 4972 and 4973 could not be summarily assessed as math errors based on the Form 1040. Moreover the GCM concluded that there was no substantiation omission, within the meaning of section 6213(g)(2)(D) where a taxpayer does not attach Form 5329 to report excess contribution excise taxes. Excess contributions and the appropriate excise tax are reported on Form 5329, which must be attached to Form 1040. However, Form 5329 calculates a tax not otherwise reported on Form 1040 and Form 1040 does not provide for reporting the excise tax. Therefore, the GCM concluded that math error procedures may not be used when Form 5329 is not attached, even if it were possible to determine from other information on the return that an excess contribution had been made.

CONCLUSIONS

Issue 1: If a failed Roth IRA conversion is not recharacterized the amount that the taxpayer attempted to convert is treated as a regular distribution from the traditional IRA, including the imposition of the 10 percent additional tax on early distributions (unless an exception applies) and is treated as a regular contribution to the Roth IRA subject to the 6 percent excise tax on excess accumulations to the extent it is an excess Roth contribution.

If a taxpayer made a failed Roth IRA conversion and the due date to recharacterize the failed conversion has passed, the taxpayer may submit a request for a private letter ruling that extends the due date to recharacterize the failed conversion pursuant to Treas. Reg. 301.9100-3.

Issue 2: As the decision whether to grant an extension of time to recharacterize a failed IRA conversion is not authority granted to the National Taxpayer Advocate by statute or delegation, the Taxpayer Advocate does not have any discretion to allow the taxpayer to recharacterize a failed IRA conversion. In order for the Taxpayer Advocate to fully assist the taxpayer, the Taxpayer Advocate should be apprized of the requisite procedures for requesting an extension of time to recharacterize the failed IRA conversion after the deadline for recharacterizing an IRA contribution.

Issue 3: Consistent with the legislative history of IRC § 6213, the math error assessment procedures may only be employed if it is apparent from the face of the return which entry is incorrect. In the situation you describe, it is not apparent from

the face of the return which return entry is incorrect, e.g., whether the taxpayer's AGI or conversion amount is the incorrect entry, nor can you determine the taxpayer's modified AGI.

The examples above show that even in cases where it would appear that the procedure could be used because the deduction claimed was inconsistent with the other information on the return, the math error procedures still would not apply if there was some uncertainty about what the taxpayer intended. The math error exception may only be utilized if it is absolutely clear what the taxpayer intended. We do not believe that in the Roth conversion situation you describe the taxpayer's intention is absolutely clear. Since Form 5329 is not attached to the return, you cannot determine whether the amount distributed from the IRA is subject to the 10 percent additional tax on early distributions imposed under IRC § 72(t) because the taxpayer may qualify for an exception to the additional 10 percent tax. In addition, you cannot determine from the face of the return whether the taxpayer made other Roth IRA contributions for the taxable year, so you cannot determine whether the failed Roth IRA conversion is subject to the excise tax imposed on excess Roth IRA contributions under IRC § 4973, nor is Form 5329 attached.

Accordingly, since the Internal Revenue Service is not permitted to make determinations about a taxpayer's intention when making assessments pursuant to the math error procedures, assessments made as a result of a failed Roth IRA conversion (i.e., the additional tax under IRC § 72(t) and the excise tax on excess contributions under IRC § 4973) must be made pursuant to deficiency procedures.