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"The Pension Specialists"

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2008 IRS Reporting for a Conversion of Eligible Retirement (ERP) Funds to a Roth IRA

The IRS has recently issued the 2008 instructions for Forms 1099-R and 5498. Their guidance on the conversion subject from eligible retirement plans was somewhat surprising.

On the distribution side, when the plan sends the money to the Roth IRA custodian, it will generate a Form 1099-R reporting the distribution as fully taxable. On page 4 of the instructions it reads:

> "For a direct rollover of an eligible rollover distribution to a Roth IRA (other than from a designated Roth account), report the total amount rolled over in box 1, the taxable amount in box 2a, and any basis recovery amount in box 5. (See the instructions for box 5 on page 9.) Use Code G in box 7."

This was expected. The individual is required to include in income (i.e. pay taxes) the amount being converted. This is true whether the funds are coming from an IRA or other eligible retirement plan.

On the contribution side, the IRS has always had the rule that a direct rollover is to be reported as a rollover in box 2 of the Form 5498. In a rollover situation, a distribution is actually made to the individual (via check or cash), who then re-deposits the funds within 60 days into an IRA. In the direct rollover situation, the funds are sent directly to the IRA custodian on behalf of the individual (i.e. the deemed payee).

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IRS Issues Limited Guidance in Converting 401(k) Funds to a Roth IRA

Individuals are starting to act on the fact that the Roth IRA has a tremendous value as a financial planning tool. Effective as of January 1, 2008, an individual may convert some or all of his or her account balance in a 401(k) plan or other employer retirement plan (ERP) to a Roth IRA. It no longer is required for an individual to first do a direct rollover to a traditional IRA and then convert from the traditional IRA to the Roth IRA. Now, the individual may instruct the 401(k) or other Employer Retirement Plan (ERP) to directly roll over a specific sum from the ERP to a Roth IRA. In order to convert funds from an ERP to a Roth IRA an individual must comply with the same eligibility rules applying to IRA conversions. The individual will need to include the deemed distribution amount in his or her income and pay tax on it.

The IRS recently issued limited guidance in Notice 2008-30. It is not comprehensive guidance and individuals and financial institutions need to understand this fact. Financial institution are now being asked to establish new Roth IRAs to receive these conversion contributions or to make such conversion contributions to an existing Roth IRA. A financial institution will certainly want to accept such deposits. In general, they will be very long term deposits as individuals will normally withdraw funds from a Roth IRA (which generates tax-free income) only as a last resort.

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Converting 401(k) to Roth IRA, Continued from page 1

The Pension Protection Act of 2006 (PPA 06) changed the definition of a "qualified rollover contribution" to a Roth IRA so that on or after January 1, 2008, the funds qualifying to be rolled over could come from certain eligible employer plans (e.g. 401(k) plans, profit sharing plans, 403(a)plans, 403(b) plans and certain eligible governmental section 457(b) plans) in addition to being able to come from a traditional IRA, SEP-IRA or SIMPLE IRA or another Roth IRA.

There are three ways to accomplish an IRA conversion: (1) an internal transfer within the same financial institution from the traditional IRA to the Roth IRA; (2) an actual distribution to the individual from the traditional IRA followed by a rollover contribution to the Roth IRA; and (3) an external transfer from the custodian/trustee of the traditional IRA to the custodian/trustee of the Roth IRA. Conversion transactions need to be reported on Form 1099-R and Form 5498 regardless of which method is used to do the conversion.

There will only be two ways in which a conversion from an ERP to a Roth IRA will be able to be made. First a direct rollover contribution may be made by having the ERP send the check or make an electronic payment to the Roth IRA custodian/trustee. Secondly, the individual may take an actual distribution from the ERP and then make a rollover contribution to a Roth IRA. The 60-day rollover requirement must be met under the second approach. In either case; the amount rolled over must be an eligible rollover distribution as defined in Code section 402(c)(4) and the individual must include the distribution amount in his or her income to the same degree he or she would have had to include such amount in income had the funds not been rolled over.

As with an IRA conversion, an individual who converts ERP funds will not owe the 10% pre-age 50½ tax pursuant to Code section 72(t) even if he or she is younger than age 59½ . However, a person who withdraws these conversion funds within 5 years from the date of the conversion will owe a 10% excise tax unless an exception applies.

The IRS has determined that the qualified plan administrator will not need to determine if an individual is eligible to convert ERP funds to a Roth IRA. The plan administrator is allowed to assume the participant is eligible to do the conversion. The IRS does not discuss the responsibilities of the Roth IRA custodian/trustee in the conversion transaction. This is unsurprising as the ERP industry has the ear of the IRS in a way that the IRA industry does not. In order to accept a conversion contribution, the Roth IRA custodian/trustee will want and need to receive from the individual a certification that he or she is eligible to make a conversion contribution and he or she bears the tax responsibility if he or she is ineligible.

As with an IRA conversion, an individual may be eligible to do the ERP conversion at the time it is done, but later becomes ineligible. The IRS states an individual is allowed to recharacterize a conversion contribution coming from an ERP pursuant to the rules set forth in Code section 408A(d)(6). It appears the recharacterization of a conversion from an ERP to a Roth IRA would go to a traditional IRA and not be returned to the ERP. The IRS will need to issue additional guidance on the recharacterization topic.

The IRS has determined that the ERP must be written so that the participant or beneficiary must have the right to convert his or her ERP funds to a Roth IRA. The plan cannot be written to not allow an ERP participant or beneficiary to convert his or her ERP funds to a Roth IRA. In Notice 2008-30, the IRS cites Code section 401(a)(31) as requiring a plan to permit a participant or beneficiary of a participant of an eligible rollover distribution to elect a direct rollover to a Roth IRA. Code section 401(a)(31) already mandates that a plan allow a distributee to do a direct rollover to a traditional IRA. The IRS discusses the regulation covering direct rollovers and implies that it also applies when the funds are to be rolled over to a Roth IRA. The IRS mentions that the regulation does define that there are certain situations when the plan is not required to do a direct rollover. The plan is not required to permit a direct rollover if the amount to be directly rolled over is less than $500. In addition, a plan is not required to do multiple direct rollovers. We at CWF construe this to mean that the plan must allow a person to do at least one direct rollover to a traditional IRA and one

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**Converting 401(k) to Roth IRA,
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direct rollover to a Roth IRA. The IRS needs to furnish additional guidance on this issue. It is possible to read the IRS statements to mean that if the distributee directly rollovers funds from the plan to a traditional IRA then the employer would not need to allow the distributee to direct rollover the other funds to a Roth IRA or vice versa because an employer only needs to do one direct rollover. One would hope that most plans will try to accommodate its distributees and allow at least one direct rollover to each type of IRA.

We at CWF were somewhat surprised that the IRS has ruled that beneficiaries of an ERP participant are entitled to make qualified rollover contributions to a Roth IRA. That is, an ERP beneficiary is allowed to convert to an inherited Roth IRA some or all of the deceased participant's balance. An IRA beneficiary does NOT have the right to convert inherited IRA funds into an inherited Roth IRA. In order to do a conversion from an ERP, the beneficiary must satisfy the eligibility requirements. However, the IRS presently states that a plan may but is not required to permit rollovers by a nonspouse beneficiary. In the case of nonspouse beneficiaries there is only one way to do the conversion, it must be done by a trustee/custodian to trustee/custodian transfer. A nonspouse beneficiary will be able to recharacterize his or her conversion, if necessary. Required distributions from the Roth IRA will be determined under the RMD rules for inherited IRAs as explained in Notice 2007-7.

A spouse beneficiary of an ERP will be able to select from two types of conversions. First, if the spouse beneficiary elects to treat the deceased spouse's account as his or her own, then the spouse beneficiary will convert such account to his or her own Roth IRA account. Remember, the required distribution rules only apply to inherited Roth IRA account so they do not apply to the - Roth IRA of a spouse who has treated it as his or her own. Secondly, if the spouse beneficiary does not elect to treat the account as his or her own, then the account will be converted to an inherited Roth IRA and the required distribution rules will apply.

Whenever there is a distribution from an ERP, the topic of withholding needs to be discussed. The law mandates 20% withholding if the distribution is eligible to be rolled over, but the distributee elects not to do a direct rollover. Withholding is not required when the distributee elects to have a direct rollover. This same rule will apply to conversions from an ERP to a Roth IRA, including a conversion by a nonspouse beneficiary. Most individuals doing conversions will generally want to convert the entire amount (and not have any withholding) and pay the income tax related to the conversion with other personal funds. There will be some individuals who will not want to convert the entire account and will use some of the account to pay the associated income tax liability.

Technically, only 20% of the amount which would be subject to tax must be withheld. Withholding is not required with respect to any after-tax employee account balances.

The IRS states that a plan may choose to accommodate a distributee by voluntarily agreeing to withhold funds from a conversion. The IRS informs plans and distributees that section 3402(p) and related regulations set for the rules relating to voluntary withholding.

CAUTION. There is one major subject or situation which we do not believe the IRS has addressed in writing yet. There are some individuals who have basis or after-tax employee contributions within the ERP. For example, Jane Doe has participated in her employer's 401 (k) plan. She has separated from service. She has $80,000 in her account. She has an after-tax account balance of $20,000 and a taxable balance of $60,000. If the law permits it, she want to directly rollover the $60,000 to a traditional IRA and to directly rollover or convert the $20,000 of after-tax funds to a Roth IRA. Is it possible for a person to somehow just convert the nontaxable funds?

This is not a new issue. There was a time when some people tried to argue that the after-tax dollars coming out of a 401(k) plan could somehow go into a separate account within a traditional IRA and then only these after-tax dollars would be converted. It is settled that a person who has both taxable and non-taxable funds within one or more traditional IRAs is unable to convert just the nontaxable funds within a traditional IRA to a Roth IRA because of the pro-rata taxation rules.

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**Converting 401(k) to Roth IRA,
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In general, similar pro rata rules apply to distributions from an ERP when a participant has made after-tax employee contributions to the ERP. If the general pro rata rules would apply, then Jane Doe could convert $20,000 of her $80,000, but she would be required to include $15,000 in her income (75% of the $20,000) and $5,000 would not be taxable (25% of $20,000). With respect to the $60,000 not converted, if it was directly rolled over to a traditional IRA, then the individual would have a taxable portion of $45,000 and a nontaxable portion of $15,000 within the traditional IRA. Obviously, this pro-rata result is not what Jane Doe wants.

What authority exists so that the pro-rata rule would not apply?

Except as discussed below, we at CWF are unaware of any such authority. The general rule is - the pro-rata rule applies to distributions from ERP plans. There are very limited exceptions to the general rule.

There is, however, a special tax law which states - if the person does not rollover his or her entire account balance which is eligible to be rolled over, then the amount rolled over is considered as coming first from the taxable portion. The purpose of this special law - to give some special relief so that a person with after-tax dollars in an ERP would not be required to rollover the after-tax funds into a traditional IRA or other ERP. Keep in mind this special rule only applies if the entire amount is not being rolled over. It appears this rule will not be met if these funds are rolled over into the Roth IRA. The intent of the law was and is not to allow a person with after-tax dollars to convert just those after-tax funds to a Roth IRA.

Apparently some pension attorneys, accountants and other advisers believe that having two distinct distributions could be used to accomplish the desired goal. The first distribution would equal the taxable portion of the account. This amount would be directly rolled over to a traditional IRA. After a passage of a certain period of time (certainly not the same day), the individual would then request another distribution of his or her remaining account balance. His or her remaining account balance would be comprised of the after-tax contributions still within the ERP and possibly some earnings. This second distribution could then be converted into a Roth IRA.

We hope the IRS chooses to address this subject very soon because individuals are starting to convert to a Roth IRA these after-tax dollars and directly rolling over their taxable funds to a traditional IRA. For the reasons discussed above, the individuals may not realize the tax results they were expecting. Obviously, this subject is a tax subject and your customer must be acting upon the advice of his or her tax advisor.

Having said the above, it may well be that the IRS under the Bush administration could choose to be nice to individuals and allow the conversion of the after-tax dollars on a non-pro rata basis. If the IRS chooses to be nice when they don't have to be, one does not complain. Until the IRS so rules, we believe an individual may learn a tax lesson the hard way if he or she is being given two checks on the same day and does a conversion to a Roth IRA thinking that no portion of the conversion will be taxable. Such a customer may decide later that he or she will recharacterize this conversion contribution.

We will need to await additional IRS guidance on this subject. ◆

Publication 590 Tidbit #1

Change in marital status. For purposes of figuring your required minimum distribution, your marital status is determined as of January 1 of each year. If your spouse is a beneficiary of your IRA on January 1, he or she remains a beneficiary for the entire year even if you get divorced or your spouse dies during the year. For purposes of determining your distribution period, a change in beneficiary is effective in the year following the year of death or divorce.

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Required Minimum Distributions Rules for 401(k) Plans & IRAs are Similar

A financial institution's customer had withdrawn $10,000 from her IRA, and she does not wish to withdraw any more in addition to that amount. The history of her situation is this:

On 5/16/07 "Mary" rolled over $25,000 from her 401(k) plan into an IRA. In general, the same required minimum distribution (RMD) rules apply to IRAs and 401(k) plans. An RMD amount is never eligible to be rolled over, and the first amount paid out of the plan is considered to be the RMD amount. Her RMD amount from the 401(k) for 2007 was $968.75. She was ineligible to roll over $25,000.

Mary's 2007 1099-R form showed a distribution of $25,000. In box 7 a reason "G" (for a direct rollover) was inserted.

A corrected 2007 Form 1099 has been prepared showing a distribution of $24,031.25 ($25,000 - $968.75) as being directly rolled over and a new 2007 Form 1099-R showing a distribution of $968.75 (the required distribution amount) with a reason code 7 (normal/over age 59½). She will need to include $968.75 on her tax return. The amount directly rolled over ($24,031.25) will also need to be included on her tax return, but that amount will not be taxable because it is not included in her taxable income.

Since $968.75 did not qualify to be rolled over on 5/16/07, this amount is an excess contribution within the IRA. Mary will want to instruct the IRA custodian that she made this excess contribution and that she wants to withdraw the $968.75 plus the related earnings income. (CWF has a worksheet in its Form 67-W which can be used to calculate this income, as well as Form 67 that explains the consequences of making an IRA excess contribution in 2007 and withdrawing it in 2008.) Mary should include this income on her 2007 tax return even though she is withdrawing it in 2008. ◆

IRS Announces New Online EIN Application Process

The IRS now has an online system for requesting employer identification numbers. No more need to complete and file Form SS-4.

An individual can apply for an EIN online by accessing the IRS website at www.irs.gov/businesses and clicking on Employer ID Numbers under Related Topics.

An applicant will be asked to furnish various information. If the information passes various checks, then a permanent EIN will be immediately issued.

This EIN is a permanent number and can be used immediately for most business needs, including opening a bank account; applying for business licenses; and filing a tax return by mail. However no matter how a person applies for an EIN (phone, fax, mail, or online), it will take up to two weeks before the EIN becomes part of the IRS' permanent records. A person must wait until this occurs before he or she can: make an electronic payment, or pass an IRS Taxpayer Identification Number matching program.

This application is available during the following hours:

Monday-Friday 6:00a.m. to 12:30 a.m. Eastern time

Saturday 6:00 a.m. to 9:00 p.m. Eastern time

Sunday 7:00 p.m. to 12:00 a.m. Eastern time

This IRS online application process is interactive. The requester will be asked various questions. There are "Help" screens. When the application process is completed, the requester is given the option to view, print, and save his or her confirmation notice. ◆

Discussion and Illustration of Calculating the Income Related to An Excess Contribution

The purpose of this article is to illustrate that calculating the income associated with an excess contribution is a relatively easy task if the IRA personnel has the proper information available. The key information to be known or determined is: (1 the FMV Value as of the time of withdrawal and (2) the FMV at the moment immediately before the "excess contribution" was made.

Example. Karen Hall, age 52, contributed $5,000 on 4-15-07 for tax year 2006. The $5,000 was deposited into a 24 month variable time deposit initially paying 5.0% interest. The interest rate changed to 4% on October 15, 2007. Interest was to be paid semi-annually on October 15 and April 15. Interest of $125.00 was paid on October 15, 2007. On November 1, 2007 she contributed another $5,000 for tax year 2007. It is now March 15, 2008 and she wants to withdraw this $5,000 contribution for 2007 since her tax advisor has told her that she will not be able to claim a tax deduction.

The IRA custodian will want to complete the Worksheet. See the adjacent page.

1. Line 1 is to be completed with $5,000. This is the amount to be withdrawn.
2. Line 2a is to be completed with the FMV of the account as of the date of distribution. This amount is $10,285.03 and it includes the accrued interest.
3. Line 3a is to be completed with the FMV of the account as of the date immediately preceding when the excess contribution of $5,000 was made. This amount is $5,133.99. It includes accrued interest of $8.99.

   This amount of $5,133.00 is added to the $5,000 excess contribution to determine an adjusted opening balance of $10,133.39.
4. Line 4 is the total amount of income earned from November 1 to March 15.
5. Line 6 shoes the amount of $74.82 and this is the income attributable to the $5,000 excess contribution.
6. The total amount to be withdrawn is $5,074.82. The IRS asks the IRA custodian to furnish the account-holder with a special notice informing her that she is required to report this amount on her 2007 tax return as she made the contribution in 2007. Only the income of $74.82 will be taxable. However, because she is not yet age 59½, she will owe the 10% additional tax for taking a premature distribution from an IRA. ◆

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Worksheet to Calculate the Income Related to the Withdrawal of a Current-Year Contribution(s)

Custodian/Trustee Information

Name ____
Address ____
City____________________ State ______ Zip ______________
Attn: ____________________ Phone ______________

Accountholder

Name Karen Hall
Home Address ____
City____________________ State ______ Zip ______________
County ____________________ Date of Birth ______________
SSN ____________________ Plan No. ______________

IRA Account Information

Account Number ____
Type: ◯ Traditional ◯ Roth

Purpose: This form is used to calculate the interest or other income earned with respect to a current-year contribution which is being withdrawn under Internal Revenue Code section 408(d)(4). The formula set forth in IRC Regulation 1.408-4(c)(1) is being used.

Date of Contribution(s)	11-1-07	________	________
Amount of Contribution(s)	$5,000	________	________
Date of Distribution	3-15-08		

1. Amount of Current-Year Contribution(s) to be Withdrawn. — 1. $5,000.00

2. Adjusted Closing Balance:
   a. FMV (immediately prior to withdrawal) (FMV = Principal + Interest + Accrued Interest) — 2(a). 10,285.03
   b. Distributions during computation period — 2(b). 0.00
   c. Total Adjusted Closing Balance (line 2a + 2b) — 2(c). 10,285.03

3. Adjusted Opening Balance:
   a. FMV (immediately prior to contribution) (FMV = Principal + Interest + Accrued Interest) — 3(a). 5,133.99
   b. Contributions during computation period — 3(b). 5,000.00
   c. Total Adjusted Opening Balance (line 3a + 3b) — 3(c). 10,133.99

4. Subtract line 3c from line 2c (this may be a negative number) — 4. 151.64

5. Divide line 4 by line 3c (a quotient to 4 decimal places) — 5. .014964

6. Income (loss) Related to the Current-Year Contribution Being Withdrawn (multiply line 5 by line 1) — 6. 74.82

7. Total amount to be withdrawn (line 1 + 6) — 7. 5,074.82

________________________ ________________________
Signature of Custodian/Trustee Date Signature of Accountholder Date

Additional Discussion – See Reverse Side

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2008 IRS Reporting, Continued from page 1

With respect to Box 2 on the 2008 Form 5498, the IRS has added the following sentence from prior year instructions, "Also include any qualified rollover contribution, as defined in section 408A(e), from an eligible retirement plan (other than an IRA) to a Roth IRA." That is, the direct rollover of funds from an eligible retirement plan is to be reported as a rollover in box 2 and not as a conversion contribution in box 3. This is the procedure to be used until the IRS issues additional guidance.

The IRS did not change its instructions for box 3 (Roth IRA conversion amount) on the Form 5498. They still read, "Enter the amount converted or reconverted from a traditional IRA, SEP-IRA, or SIMPLE-IRA to a Roth IRA during 2008."

We at CWF have our doubts as to whether what is in effect a "Roth conversion contribution" from an eligible retirement plan should be reported as a rollover in box 2. It would seem the IRS would want this conversion contribution reported in box 3 as are the conversion contributions made from a traditional IRA. For some reason the IRS, at the present time, does not want these contributions reported in box 3.◆

Publication 590 Tidbit #2

Recognizing Losses on Roth IRA Investments. If you have a loss on your Roth IRA investment, you can recognize the loss on your income tax return, but only when all the amounts in all of your Roth IRA accounts have been distributed to you and the total distributions are less than your unrecovered basis.

Your basis is the total amount of contribution in your Roth IRAs.

You claim the loss as a miscellaneous itemized deduction, subject to the 2%-of-adjusted-gross-income limit that applies to certain miscellaneous itemized deductions on Schedule A, Form 1040. Any such losses are added back to taxable income for purposes of calculating the Alternative Minimum Tax.

HSA Question

An HSA owner asked if medical expenses incurred while he had an MSA could be reimbursed from his HSA.

The conservative answer at this time is that a person would be ineligible to reimburse themselves tax free for medical expenses incurred while they had the MSA and before they had the HSA.

IRS Notice 2004-50 contains the text for this response. That Notice explains that expenses only qualify if they occurred after the HSA was established. So, any medical expenses incurred during the time of the MSA would NOT qualify to be reimbursed tax free from an HSA.

In some areas of tax law, there are times when a person is allowed to add together time periods or amounts. One could certainly argue that is would be logical to consider the MSA and HSA as one account for purposes of this reimbursement question. The law now allows one to roll over funds from the MSA to the HSA. Unfortunately, CWF is not aware that the IRS has expressly addressed this question. Until the IRS does, there would be a tax risk associated with taking a distribution and claiming it was tax-free. Right now the rule is that there is no tax free income treatment if the expense occurred prior to establishing the HSA.

We suggest that customers pose the question to the IRS to see what their response would be. ◆

Publication 590 Tidbit #3

Rollover From a Roth IRA. You can withdraw, tax free, all or part of the assets from one Roth IRA if you contribute them within 60 days to another Roth IRA. Most of the rules for rollovers, described in chapter 1 under *Rollover From One IRA Into Another*, apply to these rollovers. However, rollovers from retirement plans other than Roth IRAs are disregarded for purposes of the 1-year waiting period between rollovers.

<u>A rollover from a Roth IRA to an employer retirement plan is not allowed.</u>

A rollover from a designated Roth account can only be made to another designated Roth account or to a Roth IRA.