The Pension Digest

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ALSO IN THIS ISSUE –

Collin W. Fritz and Associates, Inc.,
"The Pension Specialists"

IRS Issues 2009 Indexed Amounts for HSAs

The contribution limits for 2009 are increasing. The Treasury Department and Internal Revenue Service issued new guidance on the maximum contribution levels for Health Savings Accounts (HSAs) and out-of-pocket spending limits for High Deductible Health Plans (HDHPs) that must be used in conjunction with HSAs. These amounts have been indexed for cost-of-living adjustments for 2009 and are included in Revenue Procedure 2008-29, which announces changes in several indexed amounts for purposes of the federal income tax.

High Deductible Health Plans

	Minimum Annual Deductible		Maximum Annual Out-of-Pocket Expenses	
	2008	2009	2008	2009
Single Coverage	$1,100	$1,150	$5,600	$5,800
Family Coverage	$2,200	$2,300	$11,200	$11,600

Maximum Contribution Limits

	2008	2009
Single HDHP	$2,900	$3,000
Family HDHP	$5,800	$5,950

HSA Catch-Up Contributions

	2008	2009
Age 55 and Older	$900	$1,000

In addition, a fiscal year plan that satisfies the requirements for an HDHP on the first day of the first month of its fiscal year may apply that deductible for the entire fiscal year. ◆

Specific Instructions for Form 5498

File Form 5498, IRA Contribution information, with the IRS by June 2, 2008, for each person for whom in 2007 you maintained any individual retirement arrangement (IRA), including a deemed IRA under section 408(q).

An IRA includes all investments under one IRA plan. It is not necessary to file a Form 5498 for each investment under one plan. For example if a participant has three certificates of deposit (CDs) under one IRA plan, only one Form 5498 is required for all contributions and the fair market values (FMVs) of the CDs under the plan. However, if a participant has established more than one IRA plan with the same custodian/trustee, a separate From 5498 must be filed for each plan. ◆

Specific Instructions for Form 5498-SA

File Form 5498-SA, HSA, Archer MSA, or Medicare Advantage MSA Information, with the IRS on or before June 2, 2008, for each person for whom you maintained an HSA, Archer MSA, or Medicare Advantage MSA (MA MSA) during 2007. You are required to file if you are the trustee or custodian of an HSA, Archer MSA, or MA MSA. A separate form is required for each type of plan. ◆

Specific Instructions for Form 5498-ESA

File Form 5498-ESA, Coverdell ESA Contribution Information with the IRS by June 2, 2008, for each person for whom you maintained any Coverdell education savings account (ESA) during 2007.

You must report contributions, including rollover contributions, to any Coverdell ESA on Form 5498-ESA. See the instructions under Boxes 1 and 2. If no reportable contributions were made for 2007 no return is required.◆

Rollover of 401(k) Designated Roth Funds

When a Plan Participant puts money into their 401(k), they can specify that their elective deferrals will either be standard deferrals (i.e. before tax) or a Designated Roth deferral (after tax).

In this article we are primarily discussing what happens to the Designated Roth funds once they are removed from the plan.

Designated Roth Rollovers Out of a 401(k) Plan

First, what is a Designated Roth? In general, it is a special type of elective deferral made to a 401(k) plan which is very similar to the Roth IRA. Again, if certain rules are met, distributions will be tax-free as is the case with distributions from a Roth IRA. For this article, we will use the terms Designated Roth to refer to the 401(k) Designated Roth, and Regular Roth IRA to refer to the standard Roth IRA.

At some point, the participant will want to take money out of their 401(k) Designated Roth. The participant will have two options:

> He or she may directly roll over their Designated Roth funds into another 401(k) Designated Roth. Should they use this option, at some point in the future, they are still allowed to roll over their funds into a Regular Roth IRA.
>
> The Plan Participant's second option is to directly roll over their Designated Roth IRA funds into a Regular Roth IRA. They should use this option with caution. Once they have completed this transaction, they will not be allowed to roll those funds back into a 401(k) Designated Roth IRA. (We believe this restriction will be repealed at some point in the future, but at this time the restriction still applies.)

What information must the 401(k) administration furnish when Designated Roth Funds are moved?

Here is our current understanding of this topic. We have changed our position. Based on the proposed regulation, we initially understood the 401(k) administrator in a non-qualified distribution situation would inform the Roth IRA custodian/trustee of the "basis" and the amount which was not "basis."

We understand this information no longer needs to be furnished by the 401(k) administrator to the Roth IRA custodian/trustee. It will need to be furnished to the individual who will be responsible to reflect the basis properly on the Form 8606.

The Roth IRA custodian/trustee treats this rollover contribution from a 401(k) plan in the same way it treats a rollover from another Roth IRA. When the Roth IRA accountholder or beneficiary takes a distribution, he or she will need to explain the tax consequences.

The 401(k) plan administrator must make the determination whether the distribution of Designated Roth funds is qualified or non-qualified.

If qualified, the entire account balance is "basis". Box 5 of the Form 1099-R as prepared by the 401(k) plan administrator will need to be completed with this entire amount.

If non-qualified, the individual needs to be informed by the 401(k) plan administrator what amount of the total amount being directly rolled over is "basis" amount on the Form 8606 on line 22 pursuant to the instructions. The non-basis amount will be treated as "earnings" within the Roth IRA. This basis amount will need to be entered into box 5 of the Form 1099-R as prepared by the 401(k) plan administrator.

The Roth IRA custodian/trustee will make its own determination of whether or not the five-year rule has been met. It does not matter to the Roth IRA custodian/trustee if the individual had met the 5-year rule with the 401(k) plan. ◆

Rollover of Matching Contributions Made on Account of Making Elective 401(k) Designated Roth Deferrals

Another item of interest with 401(k) contributions deals with matching contributions from the employer for the Plan Participant.

The typical 401(k) plan has the employees making elective deferrals, and then the employer makes a matching contribution. For example, the employer matches an employee's elective deferrals at the rate of 50% of the employee's deferrals up to a maximum of $6,000.

Within a 401(k), a Plan participant can only make Designated Roth elective deferral contributions for himself or herself. Any employer matching contribution is not a Designated Roth contribution. At the time of withdrawal of these matching funds, the participant has the option of directly rolling over these matching contributions to a traditional IRA or converting these funds to a Roth IRA.

CWF's form #857 handles all the distribution options for the 401(k) Designated Roth IRA. CWF is currently in the process of preparing a contribution form to assist the Plan Participant in accurately identifying what type of contribution they are making—if the funds should go into a traditional IRA, or a 401(k) Designated Roth IRA. This form will aid the Plan Administrator to furnish the Plan Participant at the time of distribution. ◆

Observation About IRS Publication 590, Prohibited Transactions and Roth IRAs

What the IRS does not say can be as important as what the IRS does say. Page 48 of the IRS Publication 590 sets forth the following discussion about Prohibited Transactions (PT's) - see adjacent page.

You will note that the discussion covers traditional IRAs, but not Roth IRAs. Roth IRAs became available in 1998. The IRS certainly could have added by 2008 a section discussing PT's in the Roth IRA section of Publication 590 if it had wanted to do so. The IRS must have a reason for not doing so. For whatever reason, the IRS has chosen to not explain as fully as the IRS should the consequence(s) of having a PT occur with respect to a Roth IRA. It may be that the IRS feels the rules are so easy to understand and apply that a separate discussion should not be necessary.

We at CWF disagree. We believe the IRS should try to assist individuals and IRA/Roth IRA custodians/trustees as much as possible. Some guidance is better than no guidance. The IRS needs to explain the PT rules for Roth IRAs since there will be some differences from traditional IRAs. Roth IRA custodians/trustees will want to be vigilant to make sure they do not participate or assist with a PT transaction for Roth IRAs. As with any PT situation, the individual may well harbor ill-feelings because of their "tax losses" even though he or she wanted to do the investment.

In some cases, a PT occurring with respect to a Roth IRA will have very serious tax consequences. The general rule is that when a PT occurs the entire Roth IRA funds as of the moment of the PT will be deemed distributed as of the first day of the year. For tax purposes, a PT is retroactive. The fact that the amount of the prohibited transaction is relatively small does not matter.

Illustration #1 – Roth IRA. David Hart, age 48, has a self-directed Roth IRA with a balance of $38,000. His basis is $30,000. David owns 1,000 shares of Mutual Fund A within his Roth IRA. These shares have a value of $1,000. David decides to "sell" these shares to himself. On May 15, 2008, he writes check to the Roth IRA custodian for $1,000 and the Roth IRA custodian gives him the 1,000 shares. There has been a prohibited transaction. It does not matter that he only did a transaction affecting $1,000 of his $38,000 account balance. Both should have known better. A Roth IRA accountholder is prohibited by Code section 4975 from buying an investment for his personal investments from his Roth IRA.

We understand the tax consequences to be as follows. The $38,000 is deemed distributed as of January 1. David will explain that $30,000 is not taxable since it was the return of his basis. The $8,000 is taxable since the distribution is a nonqualified distribution and is comprised of earnings. He will pay tax at whatever marginal tax rate applies to him. He will also owe the 10% additional tax as he is not yet age 59½. Since rollovers are only permitted if the roll over contribution takes place within 60 days of the distribution date, he is ineligible to roll over the $38,000. Over the next 20 years this $38,000 would have earned tax-free income of $109,048 if an earnings rate of 7% per year would be achieved.

Similarly, a PT also occurs if the Roth IRA accountholder has his Roth IRA make a loan to him.

As we all know, a pledge is not a loan. A pledge is still a prohibited transaction. However, the tax consequences are not as onerous. They are more limited. Only the amount involved in the pledge is deemed distributed (not the entire balance). This limit makes a huge difference in the tax consequences.

Illustration #2 – Pledging a Roth IRA as Collateral Rather than selling the Mutual Fund A to himself, David pledges $20,000 of his Roth IRA ($38,000) as collateral for a car loan on May 15, 2008.

What are his tax consequences? We understand the following would be the tax consequences. The $20,000 is a deemed distribution as of January 1, 2008. These funds may no longer stay in his Roth IRA. The Roth IRA custodian will need to report this distribution on the Form 1099-R. The reason code for Box 7 will be a "5". Since David has withdrawn basis (non-taxable), he will not be required to include the $20,000 in his income. The 10% penalty tax of Code section 72 will not apply since it applies only if the distribution amount is taxable. David will be required to complete his federal income tax return to report he received the $20,000 from the Roth IRA, but he will not owe and federal taxes on account of this prohibited transaction. The $20,000 is no longer in his Roth IRA with the ability to earn tax-free income.

Conclusion. The IRS has written virtually nothing about the tax consequences of a PT occurring with respect to a Roth IRA. It would be nice if the IRS in their 2008 version of Publication 590 would discuss Roth IRA PT's. ◆

Publication 590

Prohibited Transactions

Generally, a prohibited transaction is any improper use of your traditional IRA account or annuity by you, your beneficiary, or any disqualified person.

Disqualified persons include your fiduciary and members of your family (spouse, ancestor, lineal descendant, and any spouse of a lineal descendant).

The following are examples of prohibited transactions with a traditional IRA.

- Borrowing money from it.
- Selling property to it. • Receiving unreasonable compensation for managing it.
- Using it as security for a loan.
- Buying property for personal use (present or future) with IRA funds.

Fiduciary. For these purposes, a fiduciary includes any beneficiary, one who does any of the following.

- Exercises any discretionary authority or discretionary control in managing your IRA or exercises any authority or control in managing or disposing of its assets.
- Provides investment advice to your IRA for a fee, or has any authority or responsibility to do so.
- Has any discretionary authority or discretionary responsibility in administering your IRA.

Effect on an IRA account. Generally, if you or your beneficiary engages in a prohibited transaction in connection with your traditional IRA account at any time during the year, the account stops being an IRA as of the first day of that year.

Effect on you or your beneficiary. If your account stops being an IRA because you or your beneficiary engaged in a prohibited transaction, the account is treated as distributing all its assets to you at their fair market values on the first day of the year. If the total of those values is more than your basis in the IRA, you will have a taxable gain that is includable in your income. For information on figuring your gain and reporting it in income, see Are Distributions Taxable, earlier. The distribution may be subject to additional taxes or penalties.

Borrowing on an annuity contract. If you borrow money against your traditional IRA annuity contract, you must include in your gross income the fair market value of the annuity contract as of the first day of your tax year. You may have to pay the 10% additional tax on early distributions discussed later.

Pledging an account as security. If you use a part of your traditional IRA account as security for a loan, that part is treated as a distribution and is included in your gross income. You may have to pay the 10% additional tax on early distributions, discussed later.

Trust account set up by an employer or an employee association. Your account or annuity does not lose its IRA treatment if your employer or the employee association with whom you have your traditional IRA engages in a prohibited transaction.

Owner participation. If you participate in the prohibited transaction with your employer or the association, your account is no longer treated as an IRA.

Taxes on prohibited transactions. If someone other than the owner or beneficiary of a traditional IRA engages in a prohibited transaction, that person may be liable for certain taxes. In general, there is a 15% tax on the amount of the prohibited transaction and a 100% additional tax if the transaction is not corrected.

Loss of IRA status. If the traditional IRA ceases to be an IRA because of a prohibited transaction by you or your beneficiary, you or your beneficiary are not liable for these excise taxes. However, you or your beneficiary may have to pay other taxes as discussed under *Effect on you or your beneficiary* earlier.

Exempt Transactions

The following two types of transactions are not prohibited transactions if they meet the requirements that follow.

- Payments of cash, property, or other consideration by the sponsor of your traditional IRA to you (or members of your family).
- Your receipt of services at reduced or no cost from the bank where your traditional IRA is established or maintained.

Payments of cash, property, or other consideration. Even if a sponsor makes payments to you or your family, there is no prohibited transaction if all three of the following requirements are met.

1. The payments are for establishing a traditional IRA for making additional contributions to it.
2. The IRA is established solely to benefit you, your spouse, and your or your spouse's beneficiaries.
3. During the year, the total fair market value of the payments you receive is not more than:
   a. $10 for IRA deposits of less than $5,000, or
   b. $20 for IRA deposits of $5,000 or more.

If the consideration is group term life insurance, requirements (1) and (3) do not apply if no more than $5,000 of face value of the insurance is based on a dollar-for-dollar basis on the assets in your IRA.

Services received at reduced or no cost. Even if a sponsor provides services at reduced or no cost, there is no prohibited transaction if all of the following requirements are met.

- The traditional IRA qualifying you to receive the services is established and maintained for the benefit of you, your spouse, and your or your spouse's beneficiaries.
- The bank itself can legally offer the services.
- The services are provided in the ordinary course of business by the bank (or a bank affiliate) to customers who qualify but do not maintain an IRA (or a Keogh plan).
- The determination, for a traditional IRA, of who qualifies for these services is based on an IRA (or a Keogh plan) deposit balance equal to the lowest qualifying balance for any other type of account.
- The rate of return on a traditional IRA investment that qualifies is not less than the return on an identical investment that could have been made at the same time at the same branch of the bank by a customer who is not eligible for (or does not receive) these services.

Continued on page 6

The Pension Digest

Publication 590, Continued from page 5

Investment in Collectibles

If your traditional IRA invests in collectibles, the amount invested is considered distributed to you in the year invested. You may have to pay the 10% additional tax on early distributions, discussed later. Collectibles. These include:

- Artworks,
- Rugs,
- Antiques,
- Metals,
- Gems,
- Stamps,
- Coins,
- Alcoholic beverages, and
- Certain other tangible personal property.

Exception. Your IRA can invest in one, one-half, one-quarter, or one-tenth ounce U.S. gold coins, or one-ounce silver coins minted by the Treasury Department. It can also invest in certain platinum coins and certain gold, silver, palladium, and platinum bullion. ◆

The Age Issue for Catch-Up IRA Contributions for 2007

For 2007, an individual was authorized to contribute $4,000 to an IRA if he or she was not age 50 or older as of December 31, 2007 and $5,000 if he or she was age 50 or older. Individuals age 50 or older (but not 70½ or older for traditional IRAs) were eligible to contribute an additional $1,000. It is assumed the individual was otherwise fully eligible to make the IRA contribution. The maximum catch-up contribution for 2007 was $1,000.

You may have had some individuals who were age 49 as of December 31, 2007, but who turned 50 before April 15, 2008. As we all know, the tax rules authorize an individual during the period of January 1, 2008 to April 15, 2008 to make a contribution with respect to the 2007 tax year. Some or all of these individuals would like to contribute the additional $1,000 but they are ineligible since they were not age 50 as of December 31, 2007. If any such contributions were made, they would be excess contributions and would need to be corrected. ◆

The Age Issue For Catch-Up HSA Contributions for 2007

The catch-up contribution rules for HSAs are very similar to those for IRAs. The primary differences are: the catch-up amount for HSAs is not yet at $1,000 and the base contribution amount depends upon if the HDHP has single coverage or family coverage. The catch-up amount will be a $1,000 in 2009. For 2007, the catch-up amount was $800. It increases to $900 for 2008 and $1,000 for 2009.

For 2007, an individual with single coverage was authorized to contribute $2,850 to an HSA if he or she was not age 55 or older as of December 31, 2007 and $3,650 if he or she was age 55 or older. Individuals age 55 or older were eligible to contribute an additional 800. For 2007, an individual with family coverage was authorized to contribute $5,650 to an HSA if he or she was not age 55 or older as of December 31, 2007 and $6,450 if he or she was age 55 or older. Individuals age 55 or older were eligible to contribute an additional $800 for 2007.

You may have had some individuals who were age 54 as of December 31, 2007, but who turned 55 before April 15, 2008. As we all know, the tax rules authorize an individual during the period of January 1, 2008 to April 15, 2008 to make a contribution with respect to the 2007 tax year. Some or all of these individuals would like to contribute the additional $800 but they are ineligible since they were not age 55 or older as of December 31, 2007. If any such contributions were made, they would be excess contributions and would need to be corrected. ◆

The Following Due Dates Apply for Tax Year 2007

Electronic/Tape Cartridge Filing

Forms 5498* and 5498-ESA

IRS Copy – June 2, 2008

Forms 5498 and 5498-SA Participant Copy – June 2, 2008

Form 5498-ESA Participant Copy – April 30, 2008

*Participants' copies of Forms 5498 to furnish fair market value information – January 31, 2008.

Tax Year 2007 will be the last year ECC-MTB accepts tape cartridges. Due to processing deadlines, tape cartridges must be received by December 1, 2008 in order to be processed for the current year. After December 1, 2008, the only acceptable method of filing information returns with ECC-MTB will be electronically through the FIRE System. ◆

Administering Contributions to a SEP-IRA

A SEP-IRA is a traditional IRA to which SEP-IRA contributions have been made.

Personnel of IRA custodians/trustees many times have questions about contributions to SEPs. In any SEP-IRA contribution situation, it is very important to understand the type or types of contributions being made.

An employer establishes a SEP plan by executing a SEP plan agreement and each eligible employee establishing a traditional IRA if they don't already have one established. The IRS Model Forms 5305 and 5305-A have been written to authorize SEP-IRA contributions. The following types of contributions may be made to a SEP-IRA:

1. The employer contribution. There can be two types. The first is pursuant to a formula (based on compensation) where the employer contributes a certain amount and then this amount is allocated to the eligible employees. The second type is elective deferral contributions made by the eligible employees pursuant to a SAR-SEP which existed as of December 31, 1996. The maximum amount eligible to be contributed for 2008 is $46,000.

2. All the other types of contributions which can be made to a traditional IRA.
   - A. Annual contributions $5,000/$6,000 for 2008.
   - B. Rollover Contributions. These could come from a 401(k) plan, other employer sponsored plan, another SEP-IRA or another traditional IRA, or a SIMPLE-IRA.
   - C. Transfer Contributions. These could come from another SEP-IRA, another traditional IRA, or a SIMPLE-IRA.
   - D. Recharacterized contributions.

An IRA custodian/trustee had called to discuss the following situation. In February of 2008, Jane Client had brought in a check for $2,061 from JMC Consultants, her employer. It was initially thought that this was a rollover contribution. She established an IRA. She invested this $2,061 in Investment #1. In April of 2008, a check in the amount of $60,000 was sent by the JMC Consultants 401(k) to the IRA custodian since she had instructed to have a direct rollover. She instructed that she wanted this $60,000 invested in IRA investment #2. She did not complete another IRA plan agreement.

The contribution of $2,061 was not a rollover contribution. It was an "annual" SEP contribution made by the employer, JMC Consultants. It was a SEP-IRA contribution, probably for 2007. The check was not from a SEP-IRA custodian. The SEP contribution of $2,061 will be reported in box 8 of the 2008 From 5498. It is not reported on the 2007 Form 5498 since the contribution was made in 2008.

The contribution of $60,000 was a direct rollover from a 401(k) plan. It was certainly permissible to add this direct rollover contribution to the existing SEP-IRA. It will also be reported on the 2008 Form 5498 as a rollover contribution in box 2.

When a traditional IRA is a SEP-IRA, the SEP box in box 7 of the Form 5498 is to be checked.

The IRS has given no guidance as to when (or how) a

Continued on page 8

The Pension Digest

SEP-IRA,
Continued from page 7

SEP-IRA loses its status of being a SEP-IRA. One would think, that a SEP-IRA will always be a SEP-IRA if that is what the individual wants, but the IRS to the best of our knowledge, has never discussed this question. The individual has the right to transfer a SEP-IRA to a traditional IRA at any time or to do a roll over at any time assuming he or she is otherwise eligible.

All of the standard distribution rules that apply to traditional IRAs also apply to SEP-IRAs. This includes the required distribution rules.

There were special bankruptcy law changes enacted in 2005. Bankruptcy law, in general, allows a debtor to use various property exemptions under either federal law or state law. Federal bankruptcy law now provides that a person may claim as exempt any IRA funds to the extent of $1,000,000 plus any SEP-IRA funds. That is, SEP-IRA funds (and SIMPLE-IRA funds) qualify for an unlimited exemption whereas traditional IRA and Roth IRA funds are limited to $1,000,000. ◆

IRA Distributions by Grandparents/Educational Expenses

This article discusses whether a grandparent may realize any tax benefits when funds are withdrawn from a traditional IRA and then used to pay college expenses for a grandchild.

Unfortunately, a grandparent is unable to realize any tax benefits in this situation.

Question: What tax benefits. if any, might a grandparent who is over age 70½ realize by withdrawing funds from a traditional IRA and using such funds to pay college expenses of a grandchild?

Answer: Present federal income tax law does not provide any tax benefit to a grandparent who withdraws money from their traditional IRA and uses such funds to pay college expenses of a grandchild?

The general federal income tax rule is that a person must include in income the amount he or she withdraws from his or her traditional IRA. No matter how good the cause, the amount distributed will need to be included in income. As you know, there was an exception to this rule for 2006 and 2007 when certain distributions, if given to qualifying charities, were excluded from income. Congress is considering having this exception also apply for 2008 and subsequent years.

Currently, there are no exceptions when a distribution from a traditional IRA is not required to be included in the recipient's income. No exception exists providing that funds withdrawn from a traditional IRA need not be included in income if used to pay college expenses.

The tax laws also contain the rule that many recipients must pay an additional 10% tax. In general, a person who is younger than age 59½ must pay this 10% additional tax. There are numerous exceptions. There is an exception for a person (including a grandparent) who is younger than age 59½ who uses the funds to pay higher educational expenses of himself, herself a child or grandchild of himself or herself or a child or grandchild of his or her spouse. In this situation, the IRA accountholder is over 70½ so the exception to the 10% additional tax is inapplicable.

Is a grandparent able to qualify to claim the special deduction (up to $4,000 for 2007) for paying tuition and other educational expenses of a grandchild?

Not in the normal situation. In order to claim a tax deduction for paying tuition and other educational expenses of higher education, a grandparent or any other person must meet all three of the following requirements:

1. He or she must pay qualified education expenses of higher education;

2. He or she must pay such expenses with respect to an eligible student; and

3. The eligible student is either the taxpayer, himself or herself, a spouse or a dependent for who the taxpayer may claim an exemption on his or her federal income tax return. A grandparent is generally ineligible to claim an exemption for a grandchild.