The Pension Digest

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ALSO IN THIS ISSUE –

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

Changes Between the 2010 and 2011 Instructions for the Form 1099-R

1. IRS Ends Pilot or Trial Truncation Program Effective for 2011 Forms.

The 2011 Form 1099-R is required to be completed to show the recipient's complete identifying number (SSN) on all copies of the forms.

2. Box 7 has two boxes. In the first box, the IRA custodian will insert the reason code describing the distribution. The second box is to be checked if the distribution is from a traditional, SEP, or SIMPLE IRA.

After receiving a suggestion from CWF, the IRS changed the last sentence to read, "Do not check the box for a distribution from a Roth IRA or for an IRA recharacterization." Before it read, "it is not necessary to check the box for a distribution from a Roth IRA or for an IRA recharacterization." The fact is – if this box was checked for a Roth IRA distribution, the IRS still sent a tax assessment letter asking why the recipient had not included Roth IRA distribution amount "as taxable"on their tax return.

3. The IRS has chosen to increase the discussion of prohibited transactions. This is an indication that the IRS expects IRA custodians to report prohibited transactions when they happen on account of the accountholder or the inheriting beneficiary. The new paragraph on page 2 reads, "Prohibited transactions. If an IRA owner engages in a prohibited transac-

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Changes Between the 2010 and 2011 Instructions for the Form 5498

1. IRS Ends Pilot or Trial Truncation Program Effective for 2011 Forms. The 2011 Form 5498 is required to be completed to show the recipient's complete identifying number (SSN) on all copies of the forms.

2. The IRS has issued guidance for the reporting to be done when the initial beneficiary dies and the inherited IRA funds will now be paid to the successor beneficiary.

In the case of successor beneficiaries, the IRA custodian is to apply the preceding beneficiary titling rules by treating the prior beneficiary as the decedent and the successor beneficiary as the beneficiary.

If the original IRA was titled, "Brian Willow as IRA beneficiary of Joan Maple," then the inherited IRA will now be titled, "Maurice Poplar as beneficiary of Brian Willow," if Brian dies and Maurice is his beneficiary.

Note that there is no longer a mention of the original IRA owner (e.g. Joan Maple).

There will need to be a final Form 5498 and FMV statement prepared for, "Brian Willow as IRA beneficiary of Joan Maple." Again, the IRA custodian has the choice of reporting the FMV as of the date of death or 0.

3. The deadline for 2010 IRA contributions is April 18, 2011. The deadline for

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tion with respect to an IRA, the assets of the IRA are treated as distributed on the first day of the tax year in which the prohibited transaction occurs. IRAs that include, or consist of, non-marketable securities and/or closely held investments, in which the IRA owner effectively controls the underlying assets of such securities or investments, have a greater potential for resulting in a prohibited transaction. Report the distribution as you normally would for the IRA that has engaged in the prohibited transaction. Enter Code 5 in box 7."

4. With the extension of Qualified Charitable Distributions for 2010 and 2011, the 2011 1099-R instructions again state the reporting rule that there is no special reporting by the IRA custodian for qualified charitable distributions or for qualified HSA funding distributions.

5. A new paragraph has been added discussing special distributions arising from distributions under the Employee Plans Compliance Resolution System (EPCRS). In some situations. the IRS has ruled that it will be permissible for an IRA custodian to return certain excess employer contributions (but not elective deferrals), and the earnings on them, under SEP, SAR-SEP or SIMPLE-IRA plans to the employer. In such case, the gross distribution is to be entered in box 1, 0 in box 2a and enter Code E in box 7.

6. Added a new paragraph for payments to covered expatriates (i.e. individuals who have given up U.S. citizenship). The IRA custodian is to follow the guidance provided by Notice 2009-85. ◆

Changes for the Form 5498,
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2011 IRA Contributions is April 17, 2012.

4. The IRS has added a warning to the instructions for completing Box 5, Fair market value of account.

IRA custodians servicing self-directed IRAs should heed this warning or caution.

Trustees and custodians are responsible for ensuring that all IRA assets, including those not traded on established markets or with otherwise readily determinable market value, are valued annually at their fair market value. ◆

Changes Between the 2010 and 2011 Instructions for the Form 1099-R Impacting 401(k) and Other Employer Plans

1. Boxes 10-15 have been renumbered as boxes 12 to 17 because of two changes.

The first change is the titling of the blank box to the left of former box 10 as "10 Amount allocable to IRR within 5 years" and a dollar sign has been added. If a participant who is not age 59½ or older does an internal Roth conversion rollover, and then he takes a distribution before meeting the 5-year requirement, then he or she will owe the 10% additional tax.

The second change is that the box, "1st year of design. Roth Contr." has now been given a number. It is now box 11.

Note, these boxes will be completed by the 401(k) administrator or trustee.

2. There were two changes with respect to the distribution codes chart.

Code B is now to be used to report all distributions from designated Roth accounts rather than just "nonqualified distributions," but there are two exceptions. First, use Code E for a section 415 distribution. Second use Code H for a direct rollover to a Roth IRA.

Code D has been eliminated from the instructions. One expects this to be a permanent elimination. Code D was never used with respect to IRA distributions. It was used to report the withdrawal of certain excess contributions relating to the second preceding year. ◆

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2010 Roth Conversions Containing Nondeductible Contributions – Some may wish to recharacterize

Unfortunately, there are some IRA accountholders and some tax preparer's who do not understand as well as they should, the taxation rules applying to traditional IRAs having basis. Basis is created when a person makes a nondeductible contribution to a traditional IRA or rolls over after-tax dollars within a 401(k) plan to a traditional IRA. Basis will not be taxed when it is distributed from the traditional IRA. It does not matter if the distribution is a standard distribution or one which is converted to a Roth IRA.

The traditional IRA tax rules have been settled for a long time. An IRA accountholder can make during one year or over a number of years both deductible IRA contributions and nondeductible IRA contributions. The individual must properly account for both types of contributions. This is done by completing the Form 8606.

The basic IRA taxation rules are:

1. The individual has never had the right to withdraw his or her nondeductible contributions first or last. The nondeductible contributions and the deductible contributions come out of the traditional IRA on a pro rata basis.

2. The individual must aggregate all of his or her traditional IRAs for purposes of completing the Form 8606. That is, it does no good for someone to claim that the IRA contributions made at bank #3 and bank #4 are nondeductible, whereas the contributions made at bank #1 and bank #2 were deductible.

An example. A person has 4 IRAs with a total balance of $30,000. The person knows that she has made nondeductible contributions of $10,000. If she converts the $10,000 she believes is nondeductible (and nontaxable), she will be surprised to find out that the tax rules require that she pay tax on $6,667 as the pro rata distribution rule requires. She will not pay tax on the $3,333 as this is the basis portion returned to her.

Pages 40-43 of the 2010 Publication 590 sets forth a discussion of fully and partially taxable distributions.

Set forth below is the IRS instruction to an IRA custodian as to how it is to report a 2010 Roth IRA conversion.

> **Roth IRA conversions.** You must report a traditional, SEP, or SIMPLE-IRA distribution that you know is converted or reconverted this year to a Roth IRA in boxes 1 and 2a (checking box 2b "taxable amount not determined" unless otherwise directed elsewhere in these instructions), even if the conversion is a trustee-to-trustee transfer or is with the same trustee. Enter Code 2 or 7 in box 7 depending on the participant's age. Even though 2010 conversions are generally taxable in 2011 and 2012, you must report the full amount converted on the 2010 Form 1099-R only. You do not have to issue Form 1099-R for any future year to report the 2010 conversion.

Taxpayers who misunderstood the taxation of the IRA distributions they took for their Roth conversion may still recharacterize such distribution. In such case, the conversion distribution will be treated as if it never occurred. However the individual will need to attach a note to their 2010 tax return that she did a recharacterization of a 2010 conversion. ◆

Right of an IRA Custodian to Not Follow a Surviving Spouse's Election to Treat His or Her Deceased Spouse's IRA as Own

There is no IRS authority allowing an IRA custodian to not follow or accept a surviving spouse's instruction that he or she has decided to treat the deceased spouse's IRA as his or her own IRA.

Regulation 1.408-8 Q & A 5 sets forth the rules. The election is made by the surviving spouse redesignating the IRA as an IRA in the name of the surviving spouse as an IRA owner rather than as a beneficiary.

There is no indication an IRA custodian has any authority or right to not accept the surviving spouse's redesignation.

The IRS regulation even provides that in two situations the election is made even though the surviving spouse does not expressly redesignate the IRA as his or her own. First, a "deemed" redesignation occurs if the surviving spouse was required to take an RMD. Second, a "deemed" redesignation occur if the surviving spouse contributes funds to such IRA (other than additional inherited IRA funds arising from the spouse). ◆

What's New and Different in the 2010 IRS Pub. 590, Individual Retirement Arrangements

The 2009 publication had 110 pages. The 2010 version has I08 pages. Why the decrease in number of pages?

A number of special IRA laws expired on December 31, 2009. These laws didn't apply to 2010 and so the discussion within Publication 590 in prior years was no longer needed. Discussion of hurricanes, Katrina, Rita and Wilma were deleted. The special catch-up contribution rules on account of a certain employer bankruptcies were deleted. The eligibility rules for Roth IRA conversions no longer apply.

Because of the special conversion rule allowing a person who converts traditional IRA funds to a Roth IRA in 2010 to be taxed 50% in 2011 and 50% in 2012, the IRS needed to revise substantially its discussion of converting funds from a traditional IRA to a Roth IRA. The IRS has organized Publication 590 to first discuss the rules applying to traditional IRAs and then Roth IRAs are covered in the last half of the publication.

On pages 28 and 29, the following provisions were added to the discussion of converting traditional IRA funds to a Roth IRA.

First, a TIP was added to the Converting discussion explaining that starting 2010, the $100,000 MAGI limit and the filing status requirements have been eliminated.

Second, added discussion of the special 2-year (2011/2012) taxation rule.

Third, added a paragraph discussing that a person may elect NOT to use the 2-year period. A person who does not want to use the special 2-year must make a special election on the 2010 Form 8606. This election cannot be changed after the due date (including extensions) for the filer's 2010 tax return.

Fourth, added a note to remind those electing the 2-year rule that when a person gets to 2011 and 2012 he or she may want to increase his or her withholding or make estimated tax payments.

Fifth, added a paragraph to discuss the fact that a withdrawal from the Roth IRA in 2010 after using the 2-year conversion rule will mean that a portion of the conversion amount will be taxable in 2010.

On page 63, there is an explanation of when a person may be required to accelerate the taxation of a 2010 conversion amount being taxed in 2011 and 2012. This will be the case when a person takes a distribution and that distribution is attributable to a 2010 conversion which is being taxed in 2011/2012. The general rule is – the amount of the conversion to be taxed in 2012 is accelerated first and then the amount to be taxed in 2011 is accelerated second. Remember, that conversions come out of a Roth IRA only after all annual contributions have been withdrawn. Also, remember that conversions come out in the order, oldest first, then next conversion in 2006 that conversion would be withdrawn before the 2010 conversion.

If there is a withdrawal of a 2010 conversion, then that withdrawal will be included in 2010's income not withstanding the original election to pay tax in 2011/2012.

Also, on page 63, there is an explanation of the tax rules to be applied if the Roth IRA owner using the 2-year rule dies before 2012. If the Roth IRA owner would die in 2010, then any amount not yet included in income will be included as income on IRA owner's 2010 return (i.e. final return). If the Roth IRA owner would die in 2011, then any amount not yet included in income will be included as income on the IRA owner's 2011 return (i.e. final return). If the Roth IRA owner would die in 2012, then any amount not yet included in income will be included as income on IRA owner's 2012 return (i.e. final return).

However, if the owner's surviving spouse receives the entire interest in all of the owner's Roth IRAs, then such surviving spouse can elect to continue to use the 2-year rule for himself or herself. The surviving spouse cannot change his or her election after the due date (including extensions) of his or her tax return that includes the date of the deceased spouse's death.

On page 64, the following provisions were added to the discussion of "converting" funds from a qualified retirement plan into a Roth IRA during 2010. The same rules discussed above for IRA conversions also apply to the conversions from qualified retirement plans. A person who has funds in a qualified plan and who decides

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to roll such funds to a Roth IRA may also use the 2-year rule.

On page 64, the IRS added a paragraph dealing with rolling funds over from one Roth IRA to another Roth IRA. Keep in mind that Publication 590 is written for individual taxpayers to use. It is not written or directed towards the IRA custodian. The new paragraph makes clear that if a person rolls over funds from one Roth IRA to another Roth IRA that the 5-year period used to determine if an individual's distribution is qualified does not change. The 5-year period begins on the first day of the taxable year for which the contribution was made to the initial Roth IRA. For most people, the first day of a person's taxable-year is January 1.

What the IRS should also say in the 2010 Publication 590, but does not, is that for purposes of the 5-rule, the IRS has instructed the IRA custodian that it is to prepare the Form 1099-R showing that the 5-year rule has been met only by looking to the time the individual has had his or her Roth IRA with it.

The fact that a Roth IRA custodian who has received a Roth IRA rollover contribution will indicate when appropriate that the person has not met the 5-year requirement on a subsequent distribution; this does not mean that the individual has not met the 5-year requirement, but he or she will need to explain this when the tax return is filed.

There will be times when a Roth IRA owner will need to pay the 10% additional tax on early distributions if he or she takes a nonqualified distribution. This subject is discussed on pages 65-67. The IRS has chosen to furnish on page 65 an example to illustrate a special situation. A person under age 59½ who converts traditional funds to a Roth IRA does not owe the 10% tax for the conversion. However, if the individual withdraws such conversion before a 5-year rule has been met, then he or she will owe the 10% tax. Completing the Form 8606 for the transactions gives the result that the individuals owes the 10% tax twice. He does not. It is only owed once.

On page 65, the IRS added a note. It reads, "If in 2010 you convert or rollover amounts to a Roth IRA that you are including in your income in 2011 and 2012, any amount distributed to you from your Roth IRA in 2010 may have to be included in income if it would otherwise qualify as a qualified distribution. For more information, see the instructions for Form 8606."

On page 2 of the Form 8606 instructions, the statement is made that "qualified distributions" are generally not included in income. This means then that there are some qualified distributions which may be included in income.

Page 8 states that certain qualified distributions (other than qualified first-time home buyer distributions) must be added on line 26. One must enter his or her 2010 qualified distributions on line 26 only if he or she elected the 2011/2012 taxation rule either with respect to a traditional IRA conversion or a conversion from a qualified retirement plan.

The IRS gives no explanation as to why these certain qualified distributions become taxable when a person takes advantage of the law allowing the conversion to be taxed 50/50 in 2011 and 2012. It appears that the IRS has adopted the approach that since the individual has not yet paid the income tax associated with the conversion distribution that such amount (or a portion of it) would be taxable. We at CWF are not convinced the IRS is correct on this issue.

The due date for 2010 tax returns and traditional and Roth IRA contributions is April 18, 2010 since Emancipation Day falls on Saturday, April 16, 2010.

The various income limits applying to traditional IRA and Roth IRAs had some minor changes. See the charts.

Added a paragraph to clarify or expand the discussion regarding "IRA interest" as follows.

"Although interest earned from your IRA is generally not taxed in the-year earned, it is not tax exempt interest. Tax on your traditional IRA is generally tax deferred until you take a distribution. Do not report this income on your return as tax-exempt interest. For more information on tax exempt interest, see the instructions of your tax return." Page 3.

On page 8 there is a list of what is not compensation. CRP (conservation reserve payments) has been added to this list.

On pages 9 and 10 there is discussion of Required Disclosures. There is a good explanation of the revocation right and that the disclosure statement must explain certain items in plain language. Although, CWF asked the IRS to add a discussion of the financial disclosure requirements, the IRS declined. The IRS stated that this

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publication is directed to the taxpayer and not the IRA custodian/trustee.

The IRS has added a number of provisions discussing investing IRA funds into investments other than bank time deposits and savings accounts, prohibited transactions and the reporting which the IRA custodian must do for such investments.

The general rule is that an annual IRA contribution must be in cash. Property cannot be contributed as an annual contribution. The IRS has added the following statements. "Although property cannot be contributed, your IRA may invest in certain property. For example, your IRA may purchase shares of stock. For other restrictions on the use of funds in your IRA, see Prohibited Transactions later in this chapter."

On page 48 there is a short discussion of the topic of collectibles. The rule is, with limited exceptions, an IRA may not invest in collectibles. If it does the amount invested in a collectible is considered distributed to you an you must include it in your income for that year. The IRS has added a paragraph explaining that if IRA funds were invested in a collectible and have already been included in your income, then such will not be included in your income when it is actually distributed from your IRA.

For the last couple of years, the IRS has published on its web site and in the newsletter for Retirement Plans a rollover chart. This chart has now been include in Publication 590. It may be found on page 22. This chart has been printed in previous issues of this newsletter.

On page 23, the IRS sets forth the rule that you generally must make the rollover contribution by the 60th day after the day you receive the distribution from your traditional IRA o your employer's plan. The IRS adopted CWF's suggestion that it would be helpful if the IRS would furnish an example. The IRS added the following. "Example. You received an eligible rollover distribution from your traditional IRA on June 30,2010, that you intend to rollover to a 403(b) plan. To postpone including the distribution in your income, you must complete the rollover by August 29, 2010, the 60th day following June 30." Note that Day 1 is July 1, the first day after June 30th.

For many years the IRS has included in the instructions for Form 8606 discussion of an "extended correction period" for certain contributions. This extended correction period applies to withdrawing or recharacterizing the contribution. The following Note has been added on page 32 and also on page 49.

"Note. If you timely filed your 2010 tax return without withdrawing a contribution that you made in 2010, you can still have the contribution returned to you within 6 months of the due date of your 2010 tax return, excluding extensions. If you do, file an amended return with "Filed pursuant to section 301.9100-2" written at the top. Report any related earnings on the amended return and include an explanation of the withdrawal. Make any other necessary changes on the amended return (for example, if you reported the contributions as excess contributions on your original return), include an amended Form 5329 reflecting that the withdrawn contributions are no longer treated as having been contributed."

On page 34 in the RMD section, the IRS added the following caution. "If you do not receive your RMD for 2010 until 2011, both your 2010 and your 2011 distributions will be included in your income in 2011."

On page 39, there is now a new full page discussion of qualified charitable distributions and how such will be reported by the individual and the custodian.

On page 54, a tip explaining the lengthened rollover period for certain first time home buyer situations. The TIP is that if a person took an IRA distribution to be used to buy, build or rebuild a first home and the purchase or construction was canceled or delayed, the person has 120 days rather than 60 days to roll over such distribution.

On page 59, the new income limits for Roth IRAs for 2011 are covered. If the filing status is married filing jointly or head of household, then a full contribution can be made if less than $169,000 and no contribution may be made if $179,000 or more. If the filing status is single, head of household or married filing separately (but did not live with spouse at any time during 2010), then a full contribution can be made if less than $105,000 and no contribution may be made if $120,000 or more.

On page 59, a new paragraph has been added explaining Designated Roth accounts and how they

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interrelate with Roth IRAs. A person who has met the Roth IRA eligibility requirements may make a Roth IRA contribution. This person may also be able to make Designated Roth elective deferral contributions. Designated Roth accounts are to be found in certain employer sponsored 401(k) plans. An employer may, but is not required to write its 401(k) plan to allow eligible employees to make Designated Roth elective deferral contributions. Such contributions are not excluded from an individual's income. A person is allowed to make both Roth IRA contributions (if eligible) and also make Designated Roth elective deferral contributions. A contribution to one does not impact a person's eligibility to contribute to the other.

On page 60, the IRS has added a caution discussing the determination of modified AGI for Roth IRA contribution purposes. A person's MAGI is the person's AGI as shown on the tax return as modified as follows: subtract any taxable conversion amount and any Roth IRA rollover amount from qualified retirement plans; and then add the following deductions and exclusions: (I) traditional IRA deduction; (2) student loan interest deduction; (3) tuition and fees deduction; (4) domestic production activities deduction; (5) foreign earned income exclusion; (6) foreign housing exclusion or deduction; (7) exclusion of qualified bond interest shown on Form 8815; and (8) exclusion of employer-provided adoption benefits shown on Form 8839. The caution: do NOT subtract conversion income when figuring the other AGI based phaseouts and taxable income. Subtract them from AGI only for the purposes of determining eligibility to make a Roth IRA contribution.

A paragraph is added stating that a repayment contribution is not subject any annual limit, but the total repayments cannot be more than the distribution (i.e. reservist or disaster recovery).

In summary, the IRS made numerous "small" changes to Publication 590. ◆

The Source for Correcting an Excess Roth IRA Contribution

A person may have multiple Roth IRAs or multiple traditional IRAs. For example, Jane Doe has a Roth IRA at bank #1, bank #2, brokerage firm #1 and brokerage firm #2. Jane contributed $6,000 to her Roth IRA with bank #2 on June 10, 2010. She transferred this Roth IRA to a Roth IRA annuity with an insurance company on December 15, 2010. It is now March, 2011 and her tax preparer has informed her that her high MAGI means her $6,000 contribution is an excess contribution. If not corrected, she will owe the 6% excess contribution tax of $360.

The Roth IRA annuity has very high surrender charges. The Roth IRA annuity has a term of 10 years with a 15% surrender charge for withdrawal during the first year. The insurance company does not provide any special relief for this situation. It still imposes its standard high surrender charges ($6,000 x 15% = $900).

Is the Roth IRA accountholder allowed to take her excess $6,000 (plus earnings) from one of her other three Roth IRAs? For example, the Roth IRA which she had with bank #1 has a balance of more than $20,000 and the bank penalty for an early withdrawal of $6,000 plus earnings would be $90.

No. A person must withdraw the excess from the Roth IRA to which the excess was made. A person wants to understand this rule when deciding when to make a contribution and when deciding what investment to purchase. ◆

Communicating to HSA Owners About Excess Contributions

HSA owners are making permissible contributions to their HSAs. They are also making excess contributions. It is important for HSA owners to have an understanding how excess contributions arise and that they must be corrected or adverse tax consequences will result.

Article III of Form 5305-C imposes on the HSA account owner the duty to determine whether the contribution limits as set forth in Article II have been exceeded. If so, an excess contribution has been made. The HSA account owner then must notify the HSA custodian and request withdrawal of the excess contributions plus earnings, if any.

We believe it is important that the HSA owner understands that he or she is primarily responsible to monitor and correct any excess HSA contributions. The HSA custodian is NOT primarily responsible for most excess HSA contribution situations. The HSA custodian duty to monitor for excess HSA contribution is limited to one situation.

Article I of the HSA model form (5305-C) provides that "No contributions will be accepted by the Custodian for any account owner that exceeds the maximum amount for family coverage plus the catchup contribution."

This sentence defines the maximum amount which can be contributed to an HSA. This maximum contribution amount is a separate subject from excess contributions, but it is certainly related. By definition a contribution in excess of the family contribution limit as increased by the catch-up contribution amount will be an excess contribution.

The sentence above requires the HSA custodian to monitor the limit of $7,150 (maximum amount for family coverage ($6,150) plus the catch-up contribution ($1,000)) for 2010 and 2011.

The HSA custodian is not to accept regular HSA contributions for a given year in excess of $7,150.

For the 2010 Form 5498-SA, total contributions made in 2010 (some could be for 2009) are reported in box 2 and then contributions made in 2011 for 2010 are reported in box 3. The HSA software must be able to determine the total HSA contributions for tax year 2010 and then determine if the $7,150 limit has been exceeded.

Once the limit of $7,150 is reached, there should be an administrative report generated by the computer system notifying the HSA custodian of a person's excess and the need to correct it as soon as possible.

There is no IRS requirement for the HSA custodian to track the limit for a person who has single HDHP coverage.

CWF recommends that an HSA custodian furnish its HSA owners with a disclosure as set forth below discussing the excess contribution subject.

"You, as the HSA owner, are responsible to determine whether or not an excess contribution has been made to your HSA for a given year. There are a number of reasons for this. The amount you are eligible to contribute is determined by whether you have single or family HDHP coverage. You may not have been eligible to make HSA contributions for the entire year and this can affect your permissible contribution amount. We as your HSA custodian, only have a limited duty in monitoring excess contributions. We must determine if any HSA owner has had current year contributions, exceeding $7,150. If you believe you have made an excess HSA contribution, please inform us as soon as possible. You must generally withdraw an excess contribution (plus related earnings) by your tax filing deadline or you will owe the 6% excise tax." ◆

IRS Guidance – Lactation Supplies are a Qualified Medical Expense

Amounts reimbursed for expenses relating to breast pumps and supplies that assist lactation are medical care and amounts reimbursed for such expenses under an HSA are not income to the HSA owner.

The IRS furnished such guidance in IRS Announcement 2011-14. The IRS will revise Publication 502, Medical and Dental Expenses, to include this guidance. ◆