THE Pension Digest

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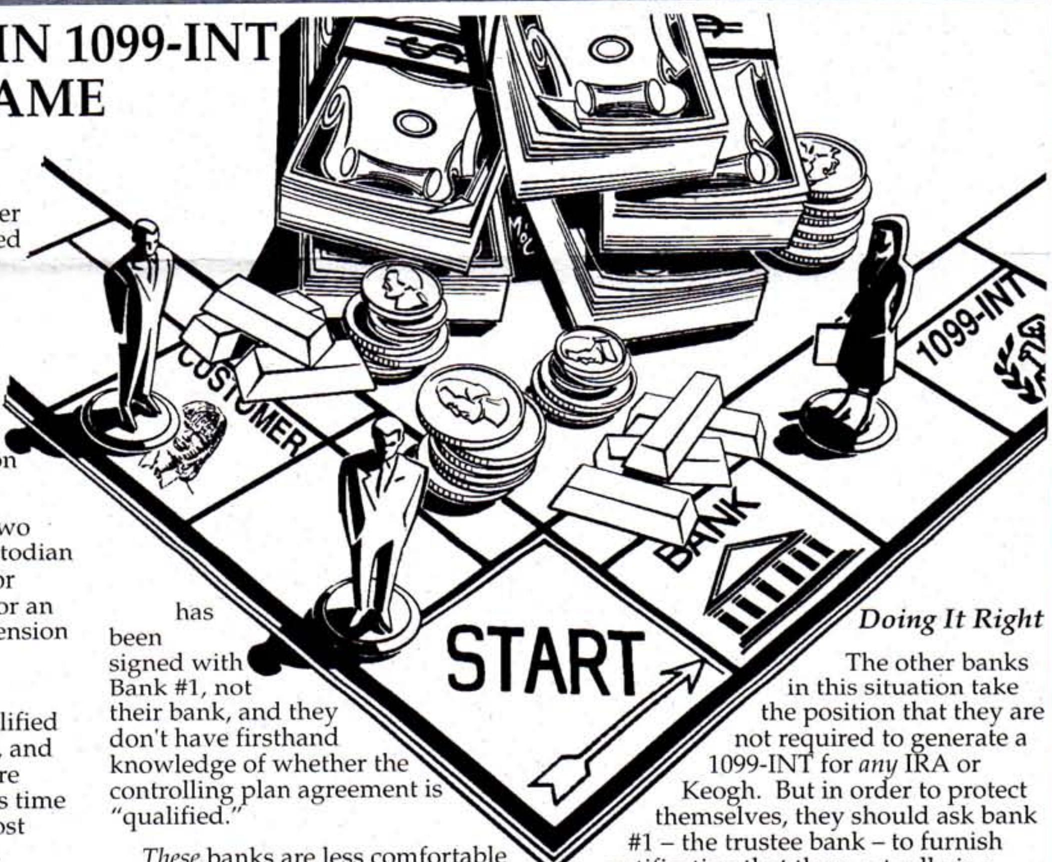
STAKES HIGH IN 1099-INT REPORTING GAME



In March of 1991 the Pension Digest contacted the IRS office in Des Moines, Iowa asking a number of questions regarding the required generating of Form 1099-INT (for interest reporting) for IRAs and Keoghs. They responded promptly in April.

We asked, "What interest reporting, if any, must an IRA custodian perform for IRA, Keogh and other qualified pension accounts?"

We indicated that there were two situations with which an IRA custodian had to decide whether it should or must produce a Form 1099-INT for an IRA or Keogh account or other pension deposit.

Situation A: The customer establishes an IRA, Keogh or qualified plan with financial institution #1, and the plan contributions or assets are used to purchase that institution's time deposits or savings accounts. Most institutions in this situation seem comfortable with *not* generating Form 1099-INT because the customer has signed their own sponsored plan agreement, and there is no doubt that this tax-sheltered plan – as specified by Code section 6049(b)(4)(B) – requires no generating of Form 1099-INT.

Probably 99% of institutions would handle this situation in this way, and be correct in doing so.

But:

Situation B: The customer establishes a self-directed IRA or Keogh account with financial institution #1, but makes certain investments in time deposits offered by other financial institutions (banks, 2, 3, 4, etc.). In this situation, these secondary banks may wonder whether they need to generate Form 1099-INT, because the plan agreement has been signed with Bank #1, not their bank, and they don't have firsthand knowledge of whether the controlling plan agreement is "qualified."

These banks are less comfortable in not preparing Form 1099-INT, and rightfully so. If the plan is not qualified, and they generate no 1099-INT, they become subject to penalties.

The 50% Who Do It Wrong

Perhaps half of the secondary banks (2, 3, 4, etc.) in Situation B might take the conservative approach and prepare the 1099-INT, knowing that *there is no penalty for generating an unnecessary 1099-INT.*

Is this okay? For the bank, yes. For the customer? Definitely not! The customer could very well find themselves in receipt of a collection letter from the IRS, asking why they failed to report and pay taxes on this earned interest.

Doing It Right

The other banks in this situation take the position that they are not required to generate a 1099-INT for *any* IRA or Keogh. But in order to protect themselves, they should ask bank #1 – the trustee bank – to furnish certification that there actually is a qualified IRA or Keogh to which these interest earnings belong.

What did the IRS say?

Mr. Eugene Storjohann, Acting Group IV Manager of the Taxpayer Service Division, in Des Moines, Iowa stated the following:

"..... You are correct in your interpretation of Code section 6049(b)(4)(B) regarding information reporting requirements where interest is paid to an organization exempt from tax under Code section 501(a) or an IRA. .....

"As you correctly note, the problem arises in Situation #B described in your letter when the financial institution is

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HOW TO SELF-AUDIT YOUR 5498 REPORTING

As an IRA custodian/trustee, you have hopefully just finished preparing the 1990 5498 forms or the magnetic media equivalent. The deadline for furnishing this information to the IRS was May 31, 1991.

How good a job did you do?

If you'd like to conduct a self-audit of your 1990 5498s, ask yourself the following questions:

Question #1: "Did I prepare the form for as many IRA accountholders and beneficiaries as the rules require?" The IRS can assess a $50 penalty for each Form 5498 that you missed.

An IRA custodian must prepare a 1990 Form 5498 for any IRA accountholder who falls into one of the following classifications. (Note that the IRS is concerned with getting certain contribution information and the IRA's fair market value (FMV) as of 12-31-90 or the date of death. Regular, spousal and rollover contributions are reported, but transfer and SEP contributions are not.)

The classifications are:

1. a regular or spousal contribution made on behalf of an accountholder during the period of 1-1-90 to 4-15-91, but only if such contribution was made for the 1990 tax year;

2. a rollover contribution made by the accountholder during the period of 1-1-90 to 12-31-90;

3. an accountholder or a beneficiary who had an account balance as of 12-31-90, or an accountholder (deceased) who had an account balance as of their date of death in 1990.

If a person falls into any of these classifications, then a 1990 Form 5498 must be generated for that person. Later, an example will be helpful in illustrating the application of these rules.

IRS Instruction Review

Before discussing the example, a review of the IRS' instructions will be helpful. Such instructions read, "File a form 5498 with the IRS on or before May 31, 1991 for each person for whom you maintained an IRA or SEP during 1990."

Please note that the IRS instructions do not seem to require a separate Form 5498 for each separate IRA plan agreement (model IRS form 5305-A). The instructions do not expressly address the topic of whether or not an IRA custodian can–or must–prepare multiple Form 5498s for the same customer when that customer has signed more than one IRA plan agreement, and not merely a separate time deposit.

The IRS instructions do seem to indicate that an IRA custodian may generate just one Form 5498. Keep in mind that the FMV portion of the Form 5498 is used by the accountholder/ taxpayer to prepare the Form 8606. On the Form 8606, the customer/taxpayer is required to add all FMVs of all IRA custodians together to arrive at his or her aggregate FMV. Thus, there should be no deficiency if the IRA custodian/trustee prepares only one form 5498, because the balances will end up being added together anyway.

A Conservative Approach

Although the IRS instructions seem to indicate that an IRA custodian may generate just one Form 5498 even though an accountholder may have multiple plan agreements, Collin W. Fritz and Associates, Ltd. has in the past taken the conservative position of recommending generating one form 5498 for each separate plan agreement. CWF intends to continue this position until the IRS clarifies its position. But each IRA custodian must decide what position they will take on this issue.

A Special Rule

A form 5498 must be generated for each source of an IRA account. If a person has his or her own IRA, and then as a beneficiary inherits another IRA, then the IRA custodian <u>must</u> generate two Form 5498s. If a person has a beneficiary's interest in his deceased mother's IRA, a beneficiary's interest in his deceased father's IRA, plus his own IRA, then the IRA custodian must generate three Form 5498s.

This separate IRA for each separate source of IRA funds also applies to surviving spouses. That is, if Jane Doe has her own IRA and she also is the sole beneficiary of her just deceased husband's IRA (John Doe), then the IRA custodian must be able to generate two Form 5498s for her. One will be for her personal IRA and the other will be "Jane Doe as beneficiary of John Doe." Both forms will list her social security number.

Note that the data processing departments and software vendors are going to have to devise systems which will generate these separate forms. There will need to be some code in addition to the social security number to instruct the computer system to generate separate forms.

An Example — How many forms must be prepared?

Pioneer Bank of Midtown, U.S.A. had 1,000 IRAs as of 1-1-90. The following events took place in 1990 and between 1-1 and 4-15, 1991:

#1. 100 IRAs were closed out in 1990. Of these 100, 25 had made contributions for 1990 before closing out. (Keep in mind that these 100/25 figures are included in the 1,000.)

#2. Of the 1,000 accounts, only 450 made regular contributions for 1990 and only 95 made a rollover contribution.

#3. 85 new IRAs with regular contributions were established in 1990, <u>for</u> 1990;

#4. 135 new IRAs with regular contributions were established in 1991 for 1990.

#5. 50 new IRAs were established in 1991 for 1990 as SEP contributions.

#6. 15 IRA accountholders died in 1990. Each had two IRA beneficiaries. 10 of the beneficiaries withdrew their shares (account balances) before 12-31-90.

#7. 20 Keogh accountholders made contributions to their Keoghs for 1990.

How many 1990 Form 5498s is Pioneer Financial required to generate?

The Calculation

The answer is 1,165. How did we arrive at this number? There were 1,000 accounts to start with. This number is reduced by 75 because these accountholders closed out their accounts and made no other contributions. Result, 925. (A form 5498 must be prepared for the 25 who made a 1990 contribution before closing out the account.) A form 5498 must be prepared for each of the new IRAs - so add 220 (135 + 85). Result, 1,145.

Since SEP contributions are not reported, no 5498s should be reported for the 50 SEP-IRAs as they were established in 1991. The 15 deceased IRA accountholders were included in the original 1,000 and the rule is that you always must generate a Form 5498 for the year of death. So, there is nothing to be added or subtracted with respect to the decedents.

Finally, add 20 5498s for the beneficiaries who still had an account balance as of 12-31-90. Result, 1165. There is no need or requirement to do a Form 5498 for those beneficiaries who have no account balance as of 12-31-90. Furthermore, the Form 5498 is for IRA reporting, so Keogh contributions or year end balances should be not be included on a Form 5498.

Question #2. "Did I prepare the forms correctly?" If not, you <u>may</u> be subject to a fine of $50.00 for each incorrect form.

Box 1. The amount in box 1 should never be more than $2,000. If there is more than $2,000, that means the customer has either made an excess

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Self-Audit —*Continued from page two*

contribution, or you have erred by reporting a SEP, Keogh or rollover contribution in the wrong box.

But the fact that the amount in box 1 is less than or equal to $2,000 does not necessarily mean the information is correct. The amount in box 1 must be the exact amount of the actual contribution made by or on behalf of that person.

An IRA custodian/trustee should have a procedure to verify that the amount in box 1 is the actual contribution amount. This can be done by comparing the amount against one or more contribution forms. Obviously, you may not find it cost effective to check every single account, but you should test a meaningful number so that you can conclude that your error rate is minimal.

Box 2. The amount in box 2 is any rollover contribution made by an accountholder during the period 1-1-90 to 12-31-90. A reportable rollover occurs when the customer was paid money from a pension plan or IRA, and then redeposits this amount into an IRA in compliance with all rollover rules. An IRA custodian/trustee should check such an amount against the rollover certification form/contribution form, which it should have in its file. *Transfers are not to be reported in box 2.*

Box 4. The amount in box 4 of the Form 5498 (the fair market value as of 12-31-90) must match the amount you disclosed to the accountholder on the January statement. An IRA custodian/trustee needs a procedure to check these amounts. If there is no match, the IRA custodian/trustee must determine which is wrong, and correct that one.

In addition to boxes 1, 2 and 4, the IRA custodian/trustee must also correctly complete its name, address and tax identification number, along with the same information for the accountholder or beneficiary.

Summary

In summary, each IRA custodian/trustee should check their 5498 forms for simple errors (more than $2,000) and for more complex errors. You want your 5498s to be as correct as possible to avoid possible fines.

However, it is interesting to note that the penalties under Internal Revenue Code sections 6721 and 6722 do not apply to Form 5498, which is filed under section 408(i). The penalty for failure to file Form 5498 is $50 per return with no maximum. This means that an argument exists that an IRA custodian/trustee should not be subject to a penalty for preparing the form incorrectly as one would be for errors on forms covered by sections 6721 and 6722. PD

Specialized Pension Software Can be a Boon to Banks

Although a dwindling number of financial institutions still handle transactions manually, most banks – even the smaller ones – are making the most of on-line computer systems for handling an ever-increasing share of day-to-day business.

But in some departments more than others, there is a definite lag-time for the arrival of these computer technologies. In many institutions, retirement plan administration is definitely one of the laggards. This phenomenon is certainly understandable, given the extremely technical nature of the governing IRS regulations on IRAs, SEPs and qualified retirement plans, and the fact that most software companies serving broad-based processing needs are not pension specialists.

But – whether understandable or not – it is definitely unfortunate, for these very complexities make the manual handling of retirement plan transactions extremely tedious, and filled with opportunities for error.

Complicated functions now handled manually in many institutions include: calculating earnings projections when opening an IRA account, calculating required minimum distributions (RMDs) for accountholders 70-1/2 years or older, generating specialized IRS reporting forms, administering self-directed IRAs, and other related retirement plan functions.

There Are Exceptions

Some of these needs are being met by data processing service bureaus outside financial institutions. This works well for many, but some banks would prefer the flexibility of handling these transactions and calculations internally. Plus, the fees charged by most service bureaus – usually on an annual "per account" basis – can be considerable.

Software Options Now Viable

Though they've been slower in coming, a number of software products are now on the market, developed by companies that specialize in pension administration and consulting. These developments are the result of focusing both legal and data processing expertise – from within the same company – on pension administration problems. Some of these softwares can even help an institution do marketing analyses of their pension customers, and handle special informational or marketing mailings.

The major pension administration companies – including Collin W. Fritz and Associates – offer a variety of these specialized products. If you have complicated pension administration functions that are being handled manually, now is a good time to contact the firm that assists you with consulting, forms, training and other pension services. There are more choices now than ever before. Consider contacting *several* companies whenever possible, as you search to find the most capable software for your particular administration needs. PD

(CWF can be contacted at 800-346-3961.)

Fed's Greenspan Backs Enhanced IRAs

Federal Reserve Chairman and widely respected economist Alan Greenspan has joined the ranks of those who support giving more generous tax breaks to IRA accountholders, even though his endorsement is more of a "worth a try" nature than an enthusiastic embrace of the concept.

Greenspan noted that he is generally not opposed to reducing taxes to provide economic benefits, adding that the expanded IRA proposals are "probably worth a chance."

As has been reported here previously, Congressional IRA backers are supporting various combinations of the following IRA revisions:

- allow accountholders to withdraw IRA funds without penalty to pay for first home, for education or for catastrophic medical expenses;
- allow *all* taxpayers — regardless of other retirement plan participation — to make a deductible IRA contribution of up to $2,000, and/or;
- create a new kind of "front-ended" IRA, with no initial deductibility, but no penalty or taxation when withdrawing principal and earnings after a five-year period.

Proponents of these new "IRA enhancements" contend that they will boost the U.S. savings rate, which is considerably less than many other industrialized nations.

Opponents say they will result in transferred, rather than new, savings, at a great cost in lost tax revenues. PD

1099-INT—*Continued from page one*

paying interest to the bank where the trust agreement is established.

"Since there are penalties for failing to issue information returns where they are required and no penalties for issuing information returns where none is required, the easy solution is, in case of doubt, to issue the returns. Alternatively, the payer may request certification from the payee bank that the investment is a qualified IRA or retirement plan" (and not issue a return if it is).

"The IRS, of course, would prefer the latter course of action. ....." (Emphasis added.)

In summary, Mr. Storjohann has indicated that the IRS would prefer that a financial institution in Situation #B ask for certification that the IRA or qualified plan is "qualified," and — if so indicated — not produce a Form 1099-INT. Presumably, the IRS does not want to be put through the time-consuming task of determining that income reported as taxable is not actually taxable since it was earned by a tax exempt IRA, Keogh or other qualified plan.

Keep Customers Happy

CWF believes that your IRA, Keogh and other depositors of pension funds do not want to have to take the time to explain to the IRS why income reported as taxable to them is actually not taxable. For those of you who have had to furnish explanations to the IRS, you can understand that it can take many letters and much time to convince the IRS that the income reportable as taxable by your institution actually is not taxable. If this happens, you will have some very disgruntled customers.

(Please note that this article has dealt only with the subject of generating the Form 1099-INT for IRAs, Keoghs and other qualified plans. This article does not address the subject of when a financial institution must generate the Form 1099-DIV, because most banks do not have to generate or report dividends. Just be aware that the rules are different. The general rule is that the payer of the dividend must always generate the reporting form. The reporting rules for dividends are found in Internal Revenue Code section 6042(a) and not section 6049 as for interest reporting. Section 6042 does not contain an express exception authorizing no reporting for IRAs and Keoghs as does Section 6049.) PD

✓✓✓✓✓✓✓✓✓✓✓✓✓✓Check It Out

Facts/Question: It is now after April 15, 1991, and our customer has told us, because of inadequate earnings he was not eligible for the full $2,000 IRA contribution they made in 1990 for 1990. He has an excess of $500. He has filed his tax return. What needs to be done to correct the 1990 tax return and what needs to be done to avoid the 6% excise tax for future years?

✓ Answer. First, the customer owes the 6% excise tax or $30 ($500 x 6%) for the 1990 tax year. To pay this tax he should complete the 1990 Form 5329 and attach it to a Form 1040X (amended tax return form), attach his check for $30 plus the accrued interest and submit it to the IRS.

He will also owe this 6% excise tax for 1991 unless he "corrects" it on or before 12-31-91. He has two choices for correcting it.

He can withdraw the excess contribution amount of $500. The earnings attributable to this $500 do not need to be withdrawn. Assuming that he was not allowed a deduction for the $500, he will not be taxed on the payment of the $500 to him. The IRA custodian should prepare a 1991 Form 1099-R showing the gross distribution amount as $500, the taxable amount as $0 and the reason code as an 8.

Alternatively, he can leave the money sit in his IRA and apply it as his 1991 IRA contribution. It is assumed that he is eligible to make a 1991 contribution. The authority for this action is Code section 219(f)(6).

Facts/Question: In reviewing our 5498s we have found an excess contribution. The IRA contribution was made in February, 1991 for 1990. The total contribution was $3,000, an excess of $1,000. The accountholder's tax return deadline, with extensions, is past. How is it corrected?

✓ Answer. The answer is very similar to the one given for the question above. The individual owes the 6% excise tax for 1990 or $60 ($1,000 x 6%). He or she can correct the excess problem by withdrawing it or by leaving it in as her 1991 contribution, assuming she so qualifies.

Facts/Question: I have a very good customer who just came to me with the following problem. He is a farmer who had net farm income of $80,000 in 1990. On the instructions of his accountant, he contributed $750 to his Keogh and $2,000 to his wife's IRA. He made both contributions on 2-27-91 for 1990. He was, obviously, trying to be nice to his wife. He, himself, would have qualified for a much larger contribution than the $750.

The IRS has just sent them a letter telling them the $2,000 IRA contribution does not qualify to be deducted since the Keogh contribution made them active participants, and their adjusted gross income is much more than the phaseout level of $50,000. The IRS could either reduce his refund by $560, or ask to be sent a check for $560 (28% times $2,000).

What can and should these customers do, since the IRS wrote them this letter after 4-15-91?

✓ Answer. They should be upset with the accountant rather than with you.

They could consider suing the accountant if he or she gave advice as to how to split the contributions. The question has indicated that the accountant gave such advice.

The $2,000 that otherwise would have been deductible, was made nondeductible or taxable by being contributed to the IRA rather than to the Keogh. If the customer had contributed $2,750 to his Keogh, all would have been deductible.

Since the tax filing deadline of April 15, 1991, has passed, there no longer is any authority to withdraw the IRA contribution without having to apply the general IRA pro rata taxation rule. Thus, the only recourse is to now file the Form 8606 for 1990 along with Form 1040X (Amendment Form) and instruct the IRS that the contribution was nondeductible.

The customer has had an expensive tax lesson.

Can the bank now change its records to show that all the money was contributed to the Keogh? NO! PD

The Pension Digest invites your questions and comments.
Please address to "Check It Out," Collin W. Fritz & Associates, Ltd., P.O. Box 426, Brainerd, MN