THE Pension Digest

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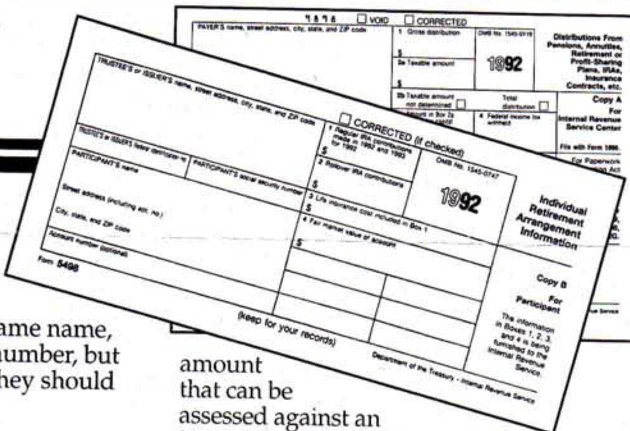


# Steps for Correcting Forms 1099-R & 5498

IRA trustees and custodians who discover 1099-R and 5498 reporting errors must file corrections with the IRS, and must furnish the corrected form to the IRA accountholder also.

Following is a summary for correcting the reporting of Form 1099-R (distributions) and Form 5498 (contributions). The procedures are virtually identical. Under current rules, institutions cannot be penalized for preparing a form "incorrectly" as in the case for other forms such as the 1099-INT, only for not preparing an original. The corrections most likely to be made now would be for the years 1989-1992.

The custodian or trustee will need to decide in what format – paper or magnetic media – it will submit the corrections to the IRS. Obviously, a paper form will need to be furnished to the IRA accountholder.

If the custodian or trustee has 250 or more corrections for a given reporting year (252 corrections out of 5,000 distri-butions), then it must use magnetic media to file these corrections with the IRS.

On the other hand, if the custodian or trustee has less than 250 corrections for a given reporting year (240 for 1991 and 200 for 1990), then it can choose to do the reporting via magnetic media or paper.

## *Type of Error #1*

*You issue the form to the right person, but with the wrong information on the form. For example, the dollar amounts are wrong or the reason code for the distribution is wrong.*

This is the easiest type of error to correct since it involves the preparation of only one form.

To make the correction, you simply prepare a corrected form (must check the ✔ corrected box) using the same name, address and social security number, but now complete the boxes as they should have been completed.

## *Type of Error #2*

*You issue the form to the wrong person.*

Step #1 is to correct the form which you prepared for the wrong person. You will need to issue the corrected form to the same person/address/social security number, etc. and you must check the "corrected" box. You need to complete the applicable boxes with 0.00 to show that the form should not have been prepared.

Step #2 is to now prepare the form using the name/address/social security number of the person who should have received the form. Note that when you prepare this form that you are preparing an original and not a correction. In the eyes of the IRS, a correction only can be done if an original has been filed previously.

Since you will in all likelihood be preparing such an original well after the submission deadline, you may want to submit a cover letter to the IRS explaining the situation, and making your case for not being fined for this late submission. (This new "original" should be sent with a separate transmittal from the trans-mittal for the true corrections.) Potential penalties are recapped below.

## *Penalties for Late Filing*

... Form 5498. The penalty for failure to file Form 5498 with the IRS in a timely fashion, or to similarly furnish the accountholder with the information to be reported on Form 5498 is $50 per failure, unless reasonable cause for such failure can be shown. There is no maximum to the amount that can be assessed against an institution in a case of multiple accounts.

... Form 1099-R. The penalty for failure to properly (timely) file the Form 1099-R is $25 per day, to a maximum of $15,000 per year.

## *Type of Error #3*

*You issue the form to the right person, but there is an error in the social security number.*

Step #1 is to correct the form you prepared with the wrong social security number. You do this by preparing a form with a check mark in the "corrected" box, showing the name, address, INCORRECT social security number, and $0.00 in the applicable boxes, an indication that the original form should not have been prepared.

Step #2 is to then prepare a new form – an "original" – using the same name, address, and the CORRECT social security number. PD

## Also In This Issue —

# Are Premature Lump Sum Distributions Qualifying for 10-Year Averaging Still Subject to the 10% Penalty Tax?

The 10% tax on premature distributions is a generally understood concept in the administration of IRAs and other retirement plans. When a distribution is received prior to age 59-1/2, it is generally subject to the 10% premature distribution penalty tax. There are limited exceptions, such as the substantially equal periodic payments option with IRA plans. But what happens in the case of a qualified retirement plan, when a lump sum distribution qualifies for 10-year forward averaging for income tax purposes? While it is understood that the distribution will be averaged over 10 years as taxable income, does this eliminate liability for the 10% premature distribution tax?

In a case decided in February of 1993 before the United States Tax Court, the answer was "no." The 10% tax on premature distributions does apply.

### *Case Description*

In this case a married couple employed by the same firm terminated service and received their profit sharing plan distributions in a lump sum. The couple filed their tax return jointly, claiming 10-year forward averaging.

This was accepted by the IRS, which however assessed an early withdrawal penalty of 10%, based on the provisions of IRS Code section 72(t).

Before the U.S. Tax Court the couple contended that they should not be subject to the 10% early withdrawal tax because this penalty is to be applied only to amounts includable in gross income. Since their distribution is being 10-year forward averaged in terms of its taxation as income, they believed the penalty did not apply to this lump sum distribution.

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# Form 5498 Reporting Alternatives for IRA Contributions

An IRA custodian/trustee has three reporting duties. It must furnish a customer statement containing the IRA's fair market value as of 12-31. It must generate a Form 1099-R for reportable distributions. It must also generate a Form 5498 to report regular and spousal contributions, rollover contributions and the fair market value as of 12-31. Note that SEP and transfer contributions are not "reportable" contributions on the Form 5498.

The primary purpose of this article is to discuss the two basic alternatives for furnishing the customer statement and the Form 5498 to the accountholders and the IRS. Many times the content and purposes of the customer statement and Form 5498 are confused.

For example, the April newsletter discussed how the Form 5498 must be completed for IRS submission purposes. The article was not intended to cover the contribution/ balance information which an IRA custodian/trustee is required to furnish to accountholders.

This article should help you evaluate what you (or your data processor) did for 1992, and will allow you to determine whether the alternative you used for 1992 is the one which you wish to use for 1993 reporting purposes.

An IRA custodian/trustee must comply with three reporting requirements.

Requirement #1. The IRA custodian/trustee must furnish the fair market value (FMV) statement to any accountholder or beneficiary with a balance as of December 31 plus those accountholders who died during the year. Note that the IRS is not sent copies of the customer statement. Also note that the only information required by the IRS to be on the customer statement is the December 31 balance.

For customer service reasons, most IRA custodians/trustees, however, choose to include on these statements much additional information on contributions, distributions, posting of earnings, etc.

Requirement #2. The IRA custodian/trustee must furnish the IRS the Form 5498 or its magnetic media equivalent on or before May 31, 1993. The Form 5498 asks for certain contribution information and the IRA's fair market value.

Requirement #3. The IRA custodian/trustee must furnish the IRA accountholder with contribution information on or before May 31, 1993. In most cases this contribution information is furnished via the Form 5498, but it need not be. A complying substitute form may be used.

Discussed below are the two primary alternatives for complying with these three requirements, but mainly requirement #3, the furnishing of contribution information. The chief difference between the two alternatives is when should, or when may, the IRA custodian/trustee furnish the contribution information? Be aware that what is sent to the accountholder in January will affect or determine what is sent to the accountholder in May. It will not affect what is sent to the IRS. The IRS is always sent the actual Form 5498, or its magnetic media equivalent.

The practical question to be answered is as follows. Is it possible to "draft" the customer statement sent out in January so that the IRA custodian will be able to mail fewer forms in May? The answer is "Yes," but the IRA custodian must add certain written provisions to the statement so that it will qualify as a substitute Form 5498. These additions are discussed below in Alternative #2.

### *Clarification by Example.*

A theoretical example based on the 1993 tax year will help explain the answer to these questions. Key items to consider are:

1. Citizens Bank will have 1,000 IRAs with balances as of 12-31-93.
2. 500 accountholders will make no contribution for 1993.
3. 300 accountholders will make contributions in 1993 for 1993.
4. 200 accountholders will make contributions in 1994 for 1993.
5. In addition, 50 new IRAs will be established in 1994 for 1993.

### *Discussion of the Alternatives*

How many customer statements, 5498s or substitute 5498s must be generated to the accountholders, and when? Remember that the IRS must always receive a copy of the Form 5498 or its magnetic media equivalent.

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**Reporting Alternatives**—*Continued from page 2*

**Alternative #1**. The IRA custodian/trustee will furnish a customer statement to the 1,000 IRA accountholders (with accounts as of 12/31/93) on or before January 31st, 1994. This statement must contain the statement that "this information is being furnished to the IRS" and it must contain the special language indicating that if the fair market value is zero and if the named person is deceased, then the personal representative of the decedent may request the fair market value as of the date of death.

In May, 1994 the IRA custodian will prepare 1,050 (includes the 50 new accounts) 5498 forms. It must submit these to the IRS on or before May 31st.

Next, the IRA custodian/trustee must mail <u>550</u> accountholders (500 existing and 50 new customers who made contributions for 1993) their respective copy of the completed Form 5498 or a complying substitute. A complying substitute will be a form (paper) containing the provisions which the IRS requires. This means the form should contain the same explanations for boxes 1, 2 or 4 as the original Form 5498. There is no requirement to send another statement to the 500 who made no contributions since only box 4 of the Form 5498 would be completed, and this would only duplicate the fair market value information furnished on the customer statement.

The IRS explanations for boxes 1, 2 and 4 read as follows:

**Instructions to Participant**

The information in boxes 1, 2, 3, and 4 is submitted to the Internal Revenue Service by the trustee or issuer of your individual retirement arrangement (IRA) to report regular or rollover contributions made to your IRA and the value of your IRA or simplified employee pension (SEP) account.

If you or your spouse was an active participant in an employer's pension plan, your IRA contributions may not be deductible. See your Form 1040 or 1040A instructions for details.

**Box 1.**—The amount shown is the contributions for 1993 made in 1993 and through April 15, 1994, to an IRA.

**Box 2.**—This is the amount of any rollover, including a direct rollover, you made in 1993. You must report the total distribution you received from your IRA on the appropriate line of your income tax return. Subtract the part of the distribution that was rolled over and enter the taxable remainder on the appropriate line of your income tax return. But if you have ever made any nondeductible contributions to your IRA, use **Form 8606**, Nondeductible IRA Contributions, IRA Basis, and Nontaxable IRA Distributions, to figure the taxable amount. If property was rolled over, see **Pub. 590**, Individual Retirement Arrangements (IRAs).

**Box 3.**—For endowment contracts only, this is the amount allocable to the cost of life insurance. Subtract this amount from your allowable IRA contribution included in box 1 to compute the amount allowable for your IRA deduction.

**Box 4.**—This is the fair market value (FMV) of your account at the end of the year. However, if a decedent is shown as the participant on this form, it may be the FMV at date of death. If a decedent's name is shown as the participant and the FMV shown is zero, the executor or administrator of the decedent's estate may request a date-of-death valuation from the financial institution.

The trustee or issuer of the plan may use the other boxes on this form to give you more information about your IRA. For example, if you were a Desert Shield/Storm participant and you made an IRA contribution for a prior year, "DS," the year for which the contribution was made, and the amount of the contribution may be shown.

You are not required to attach a copy of Form 5498 to your income tax return. Keep this form for your records. For more information about IRAs, see Pub. 590.

<u>Note that under this approach the IRA custodian prepares and mails to its accountholders a total of 1,550 forms.</u>

**Alternative #2**. The purpose of this alternative is to furnish those accountholders who made reportable contributions in 1993 – for 1993 – the necessary information <u>so that the customer statement sent in January will qualify as a substitute Form 5498.</u> The following additions should be made.

1. The form must clearly identify which information is being furnished to the IRS on the Form 5498. Not all information on some customer statements will be sent to the IRS. The statement could contain the following section, or you could possibly place an asterisk by those amounts being sent to the IRS. We prefer the use of a special section.

"The following information will be sent to the IRS when we file the Form 5498 on or before May 31, 1994.

Box 1. Regular IRA contributions made in 1993 and 1994 for 1993. ________

Box 2. Rollover IRA contributions ________

Box 4. Fair market value of account ________

Please refer to the explanation which the IRS has written for these boxes on the reverse side. Be aware that if you make a regular contribution in 1994 for 1993, we will furnish you a revised statement in May showing your final contribution amount."

2. The form must contain the written IRS explanation for the boxes 1, 2 and 4.

An IRA custodian/trustee's decision to use this alternative would require the following tasks:

The IRA custodian will furnish a customer statement to the 1,000 IRA accountholders (as of 12/31/93) on or before January 31, 1994. This statement will be specially prepared as discussed above.

*Continued on page 4*

# Clinton Tax Bill Would Reduce Cap on Plan Compensation Limit

Many retirement plans currently have a compensation limit of $200,000 ($235,840) when indexed for 1993) that may be taken into account when determining contribution and benefit amounts on behalf of an employee. But if the Revenue Reconciliation Bill of 1993 – popularly known as the Clinton Tax Bill – is enacted, this $200,000 maximum would be reduced to $150,000, effective for plan years beginning after 1993.

Just as the current cap is indexed and fluctuates with increases in the cost of living, so too would the new $150,000 cap after 1994, the first year it would be in effect.

The Bill was introduced in the House of Representatives by Ways and Means Committee Chairman Dan Rostenkowski (D-IL), and in the Senate by Daniel Moynihan (D-NY).

Unlike several major tax bills introduced during the Bush presidency, this bill proposes few changes to pension and employee benefit provisions of current law. The bill contains none of the more comprehensive provisions relative to IRA plan contributions and access to assets that were present in legislation introduced in the fall of 1992. PD

**Reporting Alternatives**—*Continued from page 3*

In May, the IRA custodian will prepare a Form 5498 (actually its magnetic media equivalent) for 1,050 of its IRA accountholders. It must submit this to the IRS on or before May 31, 1994.

Next, It must mail 250 accountholders their respective copy of the completed Form 5498 or a complying substitute. Note that the IRA custodian/trustee is furnishing this information only to those who made contributions in 1994 for 1993 since it previously furnished the 1993 contribution information to them.

Note that under this approach the IRA custodian prepared and mailed to its accountholders a total of 1,250 forms, 300 less than alternative #1.

By using alternative #2, the IRA custodian minimizes its mailing and statement preparation costs. In our hypothetical example, the savings comes from not having to prepare and mail 300 statements. Three hundred [redacted] statements may or may not influence an IRA custodian to include the additional information on the statement furnished in January. But at some point the number of statements will be sufficiently high that it will be worthwhile to add the additional provisions on the customer statement.

Additional Query. If the customer statement mailed in January can be modified to be a substitute Form 5498, can it also be modified to be a substitute Form 1099-R? If properly done, we think it can be. The combining of the 1099-R on the customer statement would also generate some cost savings. Additional paragraphs/provisions would need to be added for the customer statement to become a complying substitute Form 1099-R. We will discuss this topic in the June or July *Pension Digest* newsletter. PD

**Lump Sum**—*Continued from page 2*

### *Holding of the Court*

The court instead upheld the IRS' position, determining that under Code section 72(t) gross income is defined as "income from whatever source." The court noted that nowhere within the Code is their an exclusion for lump sum distributions. Thus their distribution is subject to the penalty tax even though their tax liability for these distributed assets is spread over 10 years, via 10-year forward averaging.

The concept of liability for early distributions, and the concept of how such distributions will be included in annual income and thus taxed, are related but distinctly different. PD

# CWF Conference Classic III — August 8-11

The agenda has now been finalized for our third annual CWF Conference Classic, an intensive workshop covering the most crucial retirement plan topics today.

Some of the topics to be covered are:

*The New Rules of Rollovers & Transfers —*
We'll examine the new rules that distinguish between IRA - to - IRA and QP - to - IRA transactions, and important strategies for rollovers from qualified plans and tax-sheltered annuities.

*Truth-in-Savings: Its Applications and Effects on Retirement Plans —*
TISA DOES apply to Individual Retirement Accounts, and we will help you to understand its effects, and what you must do to maintain compliance with its requirements.

*IRA Update '93 —*
A full-spectrum analysis of what's new in IRAs.

*MAC/PC Tools for Better Marketing —*
Explore the possibilities for enhancing internal and external marketing.

*IRA Forms Forum —*
We take you step-by-step through the completion of the more common forms required in day-to-day IRA administration. We encourage you to bring your own forms, from the IRS or any private supplier.

*The Self-Directed IRA in Today's Investment Environment*
The self-directed IRA offers greater opportunity for earnings. This IRA option may help financial institutions stem the erosion of their IRA deposit base. This conference segment provides insights into the special responsibilities that accompany this opportunity.

*Computerization and Retirement Plans —*
This segment will discuss software options and systems to help you more effectively handle the expanding demands of retirement plan reporting and administration.

*Retirement Plans and Legal Issues*
What rights do creditors have to penetrate an IRA or qualified plan to satisfy a judgment or debt? What rights does the government have to do so to collect taxes? We'll illuminate these issues and more in this conference segment. PD

**Brochures and sign-up information are now available. Call us at 1-800-346-3961 for your copy.**