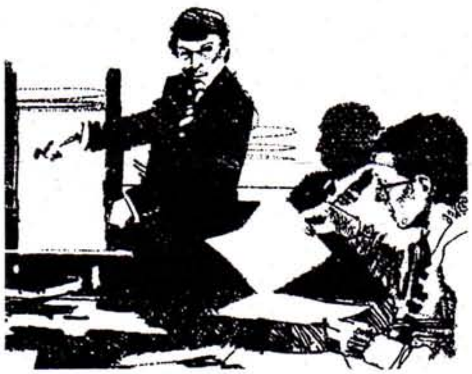
THE Pension Digest

Published Since 1984 Collin W. Fritz and Associates, Inc., *"The Pension Specialists"* April, 1994

A Refresher Course in Form 5498 Reporting



With the deadline for 1993 Form 5498 reporting looming ahead on May 31, 1994, here is some timely advice to be considered as this critical facet of IRA plan administration is completed.

Information Needed by the IRS

The IRS is seeking both contribution information, and an IRA's fair market value (FMV) as of the end of the previous tax year, in this case 1993. Failure to file a Form 5498 (to IRS and to customer) that is required carries with it a fine of $50 per account.

An IRA custodian institution must prepare a Form 5498 for every IRA account that fits into any one of the following three categories:

1. A regular or spousal IRA contribution for 1993, whether made in calendar year 1993, or in the period January 1 to April 15, 1994, FOR 1993.

2. Any rollover contribution - including a direct rollover from a qualified plan or tax-sheltered annuity - made during the 1993 *calendar* year. Unlike #1, such transactions during the January 1 to April 15 period of 1994, cannot be made for 1993.

("Transfers" of IRA assets, and SEP contributions, are not reported on the Form 5498.)

3. Any accountholder *or beneficiary* who had an account balance as of 12-31-93, or if deceased in 1993, on the date of their death.

Checklist for Boxes 1 to 4:

Box 1. The amount in box 1 is all regular and spousal contributions made by or on behalf of the accountholder during the period 1-1-93 to 4-15-94, as long as they were designated by or for the customer as a 1993 contribution. 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 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 or direct rollover contribution made by an accountholder during the period 1-1-93, to 12-31-93. An IRA custodian/trustee should check such an amount against the rollover certification form/contribution form, which it should have in its file for this customer. 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 12-31-93) must match the amount you disclosed to the accountholder on the 12-31-93 statement provided in January. 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

Continued on page 3

Also in this issue

Another IRA "Restoration" Bill?

Legislative proposals to restore IRAs to full deductibility for all workers are becoming almost as predictable as the changing of the seasons. It appears that this legislative session will be no exception, and first indications are that the bills about to be introduced will closely resemble proposals of the recent past.

Since 1986 the ability to make a tax deductible IRA contribution has been dependent upon the factors of participation (or spouse participation) in an employer's retirement plan, and income. Prior to that time, all workers could contribute and deduct up to $2,000 annually to an IRA.

If bipartisan bills now being introduced in the House by Representatives by J.J. Pickle (D-TX) and William Thomas (R-CA), and in the Senate by William Roth (R-DE) and John Breaux (D-LA) should pass, they would restore universal deductibility, and add some intriguing new wrinkles to a plan that has changed little for almost a decade.

Current IRA plans allow both deductible (for those who qualify) and nondeductible (after-tax) contributions. The former are taxed, as are the earnings, when distributed. The latter have only their earnings taxed, also upon distribution.

Continued on page 4

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Withdrawing Nondeductible IRA Contributions Commonly Misunderstood

There are some questions in IRA administration that never seem to be put to rest, but keep resurfacing as long as there are customers making contributions and taking distributions from an IRA account. One such question is that of the withdrawal of a nondeductible IRA contribution from an account, when it is no longer a "current year contribution," and subject to the rules regarding their removal.

A common scenario may resemble the following:

A worker makes a 1990 tax-year contribution to an IRA, believing it to be deductible. In February 1994 (before the 1993 tax filing deadline passes and the three-year statute-of-limitations has expired), the IRS sends him a letter denying the deduction because of active-participant and income status. The deadline has already passed for removing the amount as a current-year contribution, so it has automatically become a nondeductible contribution. What can be done now?

Erroneous Advice is Commonplace

Many who should know better will tell an IRA customer that a nondeductible contribution may be withdrawn without penalty or taxation, except taxation of any interest earned on this contribution while in the account. The truth is, this may not be so. This is only a certainty if the IRA contribution in question is the *only IRA contribution this person has ever made.*

If he or she has ever made a deductible IRA contribution, or has earnings from other nondeductible IRA contributions, then a different formula comes into play, as the following examples will show.

Accountholder has Other, Deductible Contributions

Because of an inadvertent mistake in claiming a tax deduction he is not entitled to, Tom Morgan is attempting to withdraw a nondeductible $2,000 contribution after the "current year contribution" deadline is past. It is a self-directed account, with $250 in earnings. Tom already had $7,000 in deductible IRA contributions in another account, and $750 in earnings there. Can he remove the $2,000 contribution and earnings, owing tax (and possible premature withdrawal penalty) only on the earnings?

Unfortunately, no. In such a situation, the nondeductible portion, or basis, must be compared to the combined total of deductible contributions-plus-earnings *in all IRA accounts* he holds, and any distribution will consist of part nondeductible dollars (basis), and part deductible dollars, in the same ratio. In Tom's case, each distribution will be considered to be 20% nondeductible basis ($2,000 /$10,000) and not taxed, and 80% will be considered deductible contributions plus earnings ($8,000/$10,000), and therefore taxable in the year of distribution.

What if the IRA Accountholder is Under age 59-1/2?

If the accountholder is under age 59-1/2, any *deductible* contributions *plus earnings* distributed are subject to the 10% premature distribution penalty. In Tom's case, 80% of any distribution he takes is not only taxable, but subject to this 10% penalty, because 80% of his total account balances consist of deductible contributions and earnings.

Would it be different (at pre-age 59-1/2) if his contributions had all been nondeductible, or basis? A definite "yes." In such a case, only his earnings would be subject to the premature distribution penalty. Any nondeductible amounts may be distributed to him without the 10% premature distribution penalty. If Tom's total balances consisted of $9,000 nondeductible (basis) contributions, and $1,000 earnings, then he would owe a 10% penalty (plus taxes) only on the $1,000.

Noting a Nondeductible Contribution on Form 8606

Since Tom must file an amended return correcting the $2,000 deduction he was not entitled to, he should also file a Form 8606, which will establish the amount of his nondeductible IRA contribution(s) to date at $2,000.

See Form 590 for More Information

For additional information on this topic, also see IRS Publication 590. PD

Because the IRS has found itself "running behind" in its evaluation of IRA contribution deductibility – as described in this article – we believe that it has altered some of its tax return examination procedures. We believe that 1993 tax returns filed in 1994 are being checked almost immediately for IRA deductions claimed, versus employer retirement plan "active-participant" status as noted on the taxpayer's W-2 form, versus his or her Adjusted Gross Income (AGI).

Plan Administrators Will Have IRS Help Finding Participants

As of February 1994, pension plan administrators and others will have the assistance of the Internal Revenue Service in forwarding important mail communications to those who cannot be located by other means.

While not set up exclusively for plan administrators, the Service's letter-forwarding program (announced in Revenue Procedure 94-22, February 28, 1994) may prove extremely helpful in locating missing pension plan participants, such as those eligible for benefits.

The scope of those served by the program is potentially wide, including individuals, private organizations or companies, and even government agencies. But there are limitations on the kind of information that will be forwarded, and on feedback to the sender following the letter-forwarding effort. The only communications eligible are those that include information beneficial to the recipient that could not otherwise be received by them, or information with a "humane purpose," according to the IRS.

There are further restrictions, including (1) no forwarding of bills or requests for payment, (2) there will be no acknowledgement from the IRS of the missing person having received the communication (or return if undeliverable), (3) no disclosure of the recipient's address, or whether or not the IRS possesses it in its files, and (4) no release of tax information.

Two Levels of Forwarding Volume

The procedure for seeking letter forwarding assistance from the IRS includes the following:

Number of Requests: 1-49

Requests should include:

* letter of explanation (to the IRS) describing the need for the Service's assistance

* the desired recipients' Social Security Number (without which the Service cannot attempt to forward)

* the letter to be forwarded

* there is no charge for up to 49 requests

* requests should be sent to the attention of the Disclosure Officer, at the nearest District Office (listed in most telephone directories).

* letter forwarding will only be done to the extent that it does not interfere with other Service priorities or commitments.

The letter will be sent in an IRS envelope, and the recipient will be advised of:

* the IRS' letter forwarding policy, and that the IRS has no involvement other than forwarding

* that no tax information, recipient address or forwarding confirmation is being provided to the sender

* that it is the recipient's decision whether they wish to respond to the forwarded mail

50 or More Requests

50 or more requests from a single individual or entity fall under the Service's Computerized Mailout Program (known as Project 753) with an accompanying charge of $1,750 (approximate), plus 1 cent per address search, plus 50 cents per letter forwarded. Any requests that could reasonably

Continued on page 3

Refresher — *Continued from Page 1*

complete its name, address and tax identification number, along with the same information for the accountholder or beneficiary.

ADDITIONAL 5498 TOPICS

A Separate 5498 for Each IRA?

The IRS is unclear in its instructions, as to whether a customer with five IRA plan documents must get five 5498s. The custodian is instructed by the IRS to "File a Form 5498...for each *person* (emphasis ours) for whom you maintained an IRA or SEP during 1993" (you do not report the SEP contribution, but you do report the SEP fair market value). This reference to "person" rather than "account" would seem to allow the aggregating of IRAs for 5498 reporting purposes.

Since the 5498(s) are used by taxpayers in arriving at their IRA fair market value on Form 8606, there should be no harm in an aggregate total on one Form 5498. But in the absence of any clarifying statement from the IRS, we have always taken the conservative approach and recommended that a 5498 be prepared for each IRA plan document.

A 5498 For Each IRA Source

A 5498 must be prepared for each IRA that has a different source. For example, an accountholder may have their own IRA plan, but also have a beneficiary's interest in another IRA plan, or multiple plans. This individual must receive one Form 5498 for their own plan, and one for each plan in which they have a beneficiary interest. Each 5498 is to have this individual's Social Security number, not that of the deceased accountholder. (For these beneficiary IRAs, the 5498 should be titled in this fashion: "Jane Doe as beneficiary of John Doe.")

In the case of a nonspouse beneficiary, this inherited IRA will always be titled "as beneficiary of ..." But in the case of a spouse beneficiary who elects to treat the IRA as his or her own, this "as beneficiary of ..." titling will cease for the year *in which* this election is made. If made by 12-31-93, the 5498 for tax year 1993 would be in her name only. If made on 1-1-94, it will still be titled "as beneficiary of ..." for the 1993 tax year, but not for tax years 1994 and thereafter.

How many forms must be prepared? ... A Pop Quiz

First Bank of Anytown, U.S.A. had 1,250 IRAs as of 1-1-93. The events below took place in 1993 between 1-1 and 4-15, 1994:

#1. 200 IRAs were closed out in 1993. Of these 200, 125 had made contributions for 1993 before closing out. (Keep in mind that these figures are included in the 1,250.)

#2. Of the 1,250 accounts, only 700 made regular contributions for 1993 and only 95 made a rollover contribution.

#3. 120 new IRAs with regular contributions were established in 1993, for 1993;

#4. 150 new IRAs with regular contributions were established in 1994, for 1993.

#5. 150 new IRAs were established in 1994, for 1993, as SEP contributions.

#6. 25 IRA accountholders died in 1993. Each had one IRA beneficiary. Ten of the beneficiaries withdrew their shares (account balances) before 12-31-93.

#7. 25 Keogh accountholders made contributions to their Keoghs for 1993.

How many 1993 Form 5498s is First Bank required to generate?

The Calculation: There were 1,250 accounts to start with. This number is reduced by 75 (200-125) because these accountholders closed out their accounts and made no other contributions. Result, 1,175. (A Form 5498 must be prepared for the 125 who made a 1993 contribution before closing out the account.) A form 5498 must be prepared for each of the new IRAs — so add 270 (120 + 150). Result, 1,445.

Since SEP contributions are not reported, no 5498s should be reported for the 50 SEP-IRAs. The 15 deceased IRA accountholders were included in the original 1,000 and the rule is that you must always 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 15 (25-10) 5498s for the beneficiaries who still had an account balance as of 12-31-93. Result, 1,460. There is no need or requirement to do a Form 5498 for those beneficiaries who have no account balance as of 12-31-93. Furthermore, the Form 5498 is for IRA reporting, so Keogh contributions or year end balances should be not be included on a Form 5498.

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 IRS fines. PD

Plan Administrators — *Continued from Page 2*

be aggregated to reach the 50-request, fee-based Project 753 level will be aggregated, even if separately submitted.

Requests under Project 753 are not processed on an "if-time-allows" basis as they are for 1-49 letter amounts. They are processed on a first-in, first-out basis, with an approximate 90-day interval between IRS acknowledgement of the request, and actual mail-out.

Special Guidelines Under Project 753

Requests should include:

* explanation of the need for letter forwarding

* number of possible recipients (approximate)

* acknowledgement of IRS fee for forwarding, and statement that SSNs are available for all forwarding requests (must be submitted on magnetic tape, to be requested by IRS when contract with sender is executed.

* a copy of the letter, generic and *not* personally addressed (all letters must be identical; IRS will not "sort")

* letters are to be no longer than three typewritten pages

* letter must include a prominently displayed disclaimer from the sender, with the following wording:

"In accordance with current policy the Internal Revenue Service has agreed to forward this letter because we do not have your current address. The Service has not disclosed your address or any other tax information and has no involvement in the matter aside from forwarding this letter."

Requests should be addressed to:

Internal Revenue Service
Director Office of Disclosure
CP:EX:D—Room 1603
1111 Constitution Ave., NW
Washington, DC 20224

Questions About the Program

Questions about the letter forwarding program should be addressed to:

1-49 requests -

your local (District) Disclosure Officer

50+ requests -

Ms. Connie Robinson
Office of Disclosure
(202) 622-6210 PD

401(k) Plan Administrators Warned of Possible Vesting Violation

Some 401(k) plan administrators may be startled to learn that a fairly common vesting procedure is in error, and if not corrected may subject offending plans to sanctions, up to and including plan disqualification.

The procedure involves the calculation of years of service for purposes of vesting of employer matching contributions. Some plans exclude (do not count) for vesting purposes years in which an employee does not make an elective deferral.

Treasury regulation 1.411(a)-5(b)(2) provides that a year can be excluded from vesting calculations if an employee fails to make a mandatory contribution in a given year. "Mandatory" contributions are defined in IR Code section 411 (c)(2)(C) and Treasury regulation section 1.411(c)-1(c)(4) as those required as a condition of employment, as a condition of plan participation, and as a con

Continued on page 4

✔✔✔ Check It Out ✔✔✔

With IRS Form 5498 reporting fast approaching, the following questions are particularly timely.

Question: We have had several customers open self-directed IRAs with an initial deposit in a money market account, then switch most of this deposit into a mutual fund. For example, one customer deposited $2,000 initially, then moved $1,950 into a mutual fund, leaving just $50 in the money market account.

Our concern is over reporting the correct amount in Box 4, the IRA's fair market value. Our computer system is only set up to capture balance information in typical depository type accounts. In this case, line 4 of his Form 5498 would only show $50. Is it vital that his 5498 show the self-directed balance amounts too?

✔ Unless your data-systems-generated Forms 5498 accurately reflect the fair market value of an IRA – self-directed amounts included – these forms will have to be completed manually. The fair market value includes the entirety of IRA assets, not just the most easily tracked amounts.

Question: One of our IRA customers made a current-year contribution for 1993, which proved to be an excess contribution. He withdrew all of this excess. How is this to be reported in Box 1 – "Regular IRA contributions made in 1993 or 1994, for 1993?" – on the Form 5498?

✔ Answer. The full amount contributed must be reported in Box 1 of Form 5498, including the excess. The amount withdrawn is accounted for by being reported on distribution Form 1099-R. As you are aware, an IRA accountholder has until his or her tax filing deadline to withdraw an excess contribution without paying the 6% penalty. For most this would now be past. But anyone with a tax-filing extension would have until that date to withdraw the excess contribution without penalty.

Question: We have an IRA accountholder with the following situation. She made a $2,000 contribution in September of 1992 for tax year 1992, but since she only had $1,500 of compensation, she had made an excess contribution of $500 for 1992. She has told us that she wants this excess contribution used for part of her 1993 contribution. She said she would pay the 6% excise tax which applies to an excess contribution. She contributed $1,500 on March 24, 1993 for tax year 1993. How should we prepare the 1993 Form 5498? Do we report $2,000 in box 1 or do we report $1,500? $2,000, of course, was inserted in box 1 of the 1992 Form 5498.

✔ Answer: We do not believe that the IRS has given any written direction on this specific situation. The law clearly provides that an excess contribution is converted to a regular contribution in the first available year. See Code section 219(f)(6).

The most conservative would be to insert $1,500 in box 1 and then leave it to the IRA accountholder/taxpayer to explain on his or her 1993 tax return why a contribution of $2,000 is claimed when your Form 5498 only shows a contribution of $1,500.

We feel it would be permissible for an IRA custodian to adopt a "be nice to accountholder" approach. In this case, you would report $2,000 in box 1. You would do this by doing the following: The IRA accountholder should instruct you in writing that she wants the excess to be used for the 1993 contribution. You then would need to make two special entries on your computer system. The first entry would be a $500 "miscellaneous" debit or reduction. The second entry would be a $500 contribution for 1993. 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 56401.

New SEP Documents Available ... Amending Required

The IRS has released new plan documents for Simplified Employee Pension (SEP) plans, to incorporate new provisions that resulted from the Omnibus Budget Reconciliation Act (OBRA) of 1993. This primarily concerns the reduction of the limit on employee compensation that can be considered when making a SEP contribution. OBRA '93 reduced this limit from $200,000 to $150,000, with new indexing provisions.

The changes apply to both regular SEP plans (based on IRS Form 5305-SEP), and salary-reduction SEPs (also known as SAR-SEPs), which are based on IRS Form 5305A-SEP.

CWF will be sending information on model SEP amendments within three weeks to those financial institutions which use CWF's SEP prototype.

Which Plans Must Be Amended?

Any plans for which an employer (or an employee in a SAR-SEP plan) makes contribution for plan years 1994 or thereafter, *must* have a new plan document signed.

For the sake of plan safety, even plans that have had no contributions in recent years, and/or may not have a contribution made in 1994, should ideally have a new plan document signed. This is the best course of action because an "open" plan is then truly up-to-date and in compliance, and because there then will be no fears about future contributions that could inadvertently be made to a non-complying plan.

For samples, or to purchase new SEP plan documents, please call our Customer Service Department at 1-800-346-3961. PD

"Restoration" — *Continued from Page 1*

Back-Loaded/Back-Ended IRA Again Proposed

Proposed in these new pieces of legislation is a "back-loaded" option, sometimes also referred to as "back-ended." This would be specifically for nondeductible contributions, whose *earnings would not be taxed if they remained in the account for at least five years*. This option has been proposed in past legislative sessions as well.

Attractive Penalty-Free Access Options

This legislation would also allow penalty-free access to the IRA funds – and those of 401(k)s and 403(b) tax-sheltered annuities – for college education expenses, catastrophic medical care expense, long-term unemployment, and first-time home purchases.

Passage Anything But Certain

In these days of Congressional attempts to minimize revenue-negative legislation (legislation which increases expenditures or decreases tax income without some offset), consideration is enhanced when bills are viewed as revenue-neutral. Both Senators Breaux and Roth say they intend to propose revenue-neutral ways to replace taxes that would be lost by the broadening of IRA deductibility, and elimination of penalties for some early withdrawals. Be watching for reports of further developments in upcoming issues of *The Pension Digest*. PD

401(k) — *Continued from Page 3*

dition of obtaining benefits that can be attributed to employer contributions.

Treasury regulation section 1.401(m)-1(f)(6) also defines the term "employee contribution" as any mandatory or voluntary contribution, that is treated (at time of contribution) as an after-tax employee contribution, and allocated to a separate account.

But Treasury regulation section 401(k)-1(a)(4)(ii) defines that *elective* contributions (under a qualified cash or deferred arrangement) are for several purposes considered *employer* contributions. Treasury regulations 1.401(k)-1(g)(3) and 1.402(g)-1(b) also define elective contributions to be those of the employer, *not* the employee.

Therefore, since elective 401(k) contributions are defined as employer contributions, an employee's failure to make an elective deferral cannot cause that year to be disregarded for purposes of calculating vesting of employer matching contributions.

Violating this newly clarified rule can jeopardize the qualified status of such a 401(k) plan. PD