THE Pension Digest

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1998 Form 5498

The IRS has just issued the 1998 version of the Form 5498. The form is set forth below, and the IRS' instructions to the IRA participant are set forth on page 2.

Observations

1. Box 3 has changed. For 1997 and prior years, box 3 was used to report "life insurance cost included in box 1." This information will now be reported in box 5. The Roth conversion amount (transfer or rollover) will be reported in box 3. Keep in mind that it is possible for a person to combine different rollovers/conversions into the same Roth Conversion IRA as long as they occur within the same tax year.

2. Box 6 has changed. There are now six types of IRAs rather than three as there were for 1997. The three 1997 types were IRA, SEP and SIMPLE. The three new types for 1998 are: Roth IRA, Roth Conversion, and Education IRA.

3. Box 9 is new. It is to be used to report the amount of the annual Roth contribution.

4. Box 10 is new. It is to be used to report the amount of the annual Education IRA contributions.

5. The design concept of the form is — indicate the type of IRA in box 6 and then furnish the information required for that type of IRA.

For a traditional IRA, the boxes which need to be completed, if applicable, are 1, 2, 4, 5 and 6.

For a SEP-IRA, the boxes which need to be completed, if applicable, are 1, 2, 4, 6 and 7. Keep in mind that a SEP participant may make his or her traditional IRA contribution to the same SEP-IRA which receives an "employer" contribution.

For a SIMPLE-IRA, the boxes which need to be completed, if applicable, are 2, 4, 6 and 8.

For a Roth IRA, the boxes which need to be completed, if applicable, are 3, 4, 6 and 9. Although not advised, it is permissible to combine within a nonconversion Roth IRA, an annual contribution with a rollover/conversion contribution.

For a Roth Conversion IRA, the boxes which need to be completed, if applicable, are 3, 4 and 6.

For an Education IRA, the boxes which need to be completed, if applicable, are 2, 4 and 10.

6. Deadlines. The deadline for furnishing the required information to the participant for the Education IRA is different than for the other five types of IRAs. The deadline is February 1, 1999 (since January 31 is a Sunday).

The deadline for furnishing to the participant the fair market value information for the other five types of IRAs is also February 1, 1999. The deadline for furnishing the other required information for these nonEducation IRAs is June 1, 1999 (since May 31 is a Sunday).

The deadline for furnishing the IRS with the required information is June 1, 1999 for all of the types of IRAs. PD

2828 ☐ VOID ☐ CORRECTED

TRUSTEE'S or ISSUER'S name, street address, city, state, and ZIP code		1 IRA contributions (other than amounts in boxes 2, 3, and 7-10) $ 2 Rollover contributions $	OMB No. 1545-0747 1998 Form 5498	IRA Contribution Information
TRUSTEE'S or ISSUER'S Federal identification no.	PARTICIPANT'S social security number	3 Roth conversion amount $		Copy A For Internal Revenue Service Center
PARTICIPANT'S name		4 Fair market value of account $	5 Life insurance cost included in box 1 $	File with Form 1096.
Street address (including apt. no.)		6 IRA ☐ SEP ☐ SIMPLE ☐	Roth IRA ☐ Roth conv. ☐ Ed IRA ☐	For Paperwork Reduction Act Notice and instructions for completing this form, see the 1998 Instructions for Forms 1099, 1098, 5498, and W-2G.
City, state, and ZIP code		7 SEP contributions $	8 SIMPLE contributions $	
Account number (optional)		9 Roth IRA contributions $	10 Ed IRA contributions $	

Form 5498 Cat. No. 50010C Department of the Treasury - Internal Revenue Service

Do NOT Cut or Separate Forms on This Page

1998 Form 1099-R

The IRS has just issued the 1998 version of the Form 1099-R. The form and the instructions are set forth below, but first some observations and explanations.

1. Surprisingly, the face (i.e. the boxes) on the 1998 Form 1099-R is no different than on the 1997 form.

The IRS did not change box 7 to expand the type indicator. On the 1997 form a box was checked if the distribution was made from an IRA, a SEP-IRA or a SIMPLE-IRA. The box was not checked if the distribution was from a qualified plan, 403(b), annuity or other type of retirement plan. On the 1998 form, again this box will be checked only if the distribution is from an IRA, SEP-IRA or SIMPLE IRA. There is no box to check for a distribution from a Roth IRA or an Education IRA.

2. The IRS did not create any new reason codes for Box 7 for distributions being

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Form 1099-R—*Continued from page 1*

used for education, first-time home purchase, certain medical expenses and payment of certain health insurance premiums when unemployed. The IRS also did not create a new reason code to cover the withdrawal of IRA funds from a traditional IRA for rollover or conversion to a Roth IRA. This means an IRA custodian will continue to insert reason code 1 into box 7 for such distributions. The IRA accountholder (traditional, Roth and/or Education) will be required to inform the IRS that he or she qualified for a particular exception. Be aware that the IRS could still decide that Code "2" should be used for the Roth rollover/conversion situation, although one would have expected the IRS to expressly state this in the participant's instructions if such was to be the rule.

The IRS 1997 instructions (and prior years) did not state as expressly as we would have liked, the rule that preparation of Form 1099-R was per IRA plan agreement. For example, if an individual who was age 63 maintained three different IRAs within the same financial institution and received a distribution from two of them, then two 1099-R forms would need to be prepared even if the reason code would be a 7 for both of them.

A financial institution certainly should prepare a separate Form 1099-R for distributions from different types of IRAs, traditional, Roth and Education, even if for the same accountholder.

3. The IRS instructions make clear that the financial institution is generally not required to compute the taxable amount of a distribution from a traditional IRA, Roth or Education IRA. The individual will be responsible to determine what portion of a distribution is taxable and what portion is not.

For most distributions from a traditional IRA, the financial institution is to insert the gross distribution amount in both boxes 1 and 2a. The exceptions—return of an excess contribution.

It appears that for a distribution from a Roth or Education IRA, you will insert the gross amount of the distribution in box 1 and then leave box 2a blank. The exception is, the financial institution may insert the taxable earnings portion of an excess contribution in box 2a.

4. The IRS did create three new distribution codes to handle distributions from a Roth IRA (a nonconversion Roth IRA), a Roth Conversion IRA and an Education IRA.

Code "J" is for a "Distribution from a Roth IRA in the first 5 years."

Code "K" is for a "Distribution from a 1998 Roth Conversion IRA in the first 5 years."

Code "M" is for a "Distribution from an Education IRA."

Besides the obvious new Codes, J, K and M, the descriptions of the codes in the IRS Instructions for Recipients give us further insight as to what needs to be reported. It appears that any distribution from a Roth IRA (a Roth conversion or a nonconversion Roth IRA) within the next five years will either be coded a "J" or a "K" since, of course, it is impossible to have met the five-year holding requirement. We will have to wait for further IRS instruction to see if the IRA custodian should insert two reason codes (e.g. 1J, 1K, 7J or 7K.) One would think there would need to be two codes inserted, a numeric and an alpha code. The instructions for the 1997 forms contain the following statement on use of multiple codes.

"A numeric code must be entered, except when Code P, D., E, F, G. H, L, or S is used. When applicable, you may enter a numeric and an alpha code. For example, when using a Code P for an IRA distribution under section 408(d)(4), you may also enter Code 1, if it applies. Or for a normal distribution from a qualified plan that qualifies for the 5- or 10-year tax option, enter Codes 7 and A. For a direct rollover to an IRA for the surviving spouse of a deceased participant, enter Codes 4 and G. Do not use Code 4 with Code H.

Only three numeric combinations are permitted: Codes 8 and 1, 8 and 2, or 8 and 4. If two other numeric codes are applicable, you must file more than one Form 1099-R."

It also appears that since codes J and K refer to the first five years, it will be the responsibility of the custodian/trustee to keep track of the five-year periods. (It's important to remember that the 1099-R and the IRS do not need a code for a distribution "after five years" until the year 2003, when the first Roth IRAs will have existed for five tax years.) This means Roth IRA custodians/trustees will need to record the original tax year for all Roth IRAs, even if they do not originate at their financial institution, but arrive there via transfers and rollovers. With most of five years to go, this is not an immediate problem, but, we recommend recording the original dates as soon as you open a Roth or Roth Conversion IRA or later receive the funds. Even though the distribution code may not change for some time, you can imagine how difficult it will be to get this information in 2003, 2004, etc. if you received the money in 1998, 1999 or 2000.

Remember, the five-year waiting or holding periods apply separately to all of the accountholder's Roth IRAs and each Roth Conversion IRA.

1998 Form 1099-R and the IRS' Recipient Instructions are set forth on the insert. PD

1998 IRS Form 5498

Instructions to Participant

The information on Form 5498 is submitted to the Internal Revenue Service by the trustee or issuer of your individual retirement arrangement (IRA) to report contributions and the fair market value of the account. For information about IRAs, see **Pub. 590,** Individual Retirement Arrangements (IRAs), and **Pub. 560,** Retirement Plans for Small Business.

Box 1. Shows traditional IRA contributions for 1998 you made in 1998 and through April 15, 1999. These contributions may be deductible on your Form 1040 or 1040A. However, if you or your spouse was an active participant in an employer's pension plan, these contributions may not be deductible. This box does not include amounts in boxes 2, 3, and 7-10.

Box 2. Shows any rollover, including a direct rollover to a traditional IRA, you made in 1998. Box 2 does not show any amounts you converted from your traditional IRA to a Roth IRA. They are shown in box 3. See the Form 1040 or 1040A instructions for information on how to report rollovers. If you have ever made any nondeductible contributions to your traditional IRA or simplified employee pension (SEP) and you did not roll over the total distribution, use **Form 8606,** Nondeductible IRAs (Contributions, Distributions, and Basis), to figure the taxable amount. If property was rolled over, see Pub. 590.

Box 3. Shows the amount converted (or rolled over) from a traditional IRA or SEP to a Roth IRA in 1998. You must include one-fourth of the taxable amount in your income each year for 4 years (1998 through 2001). Use Form 8606 to figure the taxable amount.

Box 4. Shows the fair market value of your account at year end.

Box 5. For endowment contracts only, shows the amount allocable to the cost of life insurance. Subtract this amount from your allowable IRA contribution included in box 1 to compute your IRA deduction.

Box 6. May show the kind of IRA reported on this Form 5498.

Box 7. Shows the SEP contributions made in 1998. If made by your employer, **do not** deduct on your income tax return. If you made the contributions as a self-employed person (or partner), they may be deductible. See Pub. 560.

Box 8. Shows the savings incentive match plan for employees (SIMPLE) contributions made in 1998. If made by your employer, **do not** deduct on your income tax return. If you made the contributions as a self-employed person (or partner), they may be deductible. See Pub. 560.

Box 9. Shows Roth IRA contributions you made in 1998 and through April 15, 1999. **Do not** deduct on your income tax return.

Box 10. Shows education IRA (Ed IRA) contributions made in 1998 on your behalf. **Do not** deduct on your income tax return. If the total of all contributions made to all your Ed IRAs this year exceeded $500, you should withdraw the excess, plus earnings, generally by April 15, or you may owe a penalty. You must keep track of your Ed IRA basis (contributions and distributions). See Pub. 590.

Moving Nondeductible IRA Contributions to a Roth IRA

A common telephone consulting question the past 75 days has been whether an IRA accountholder who has an IRA with a nondeductible basis may move just the nondeductible basis to a Roth IRA. This means the taxable portion of the traditional IRA would not be rolled over.

The answer is "no." Current tax law calls for the pro rata rule to be used for distributions from a traditional IRA which has a nondeductible basis. Current tax law also requires an IRA accountholder to aggregate all of his or her IRAs when applying this pro rata rule. This aggregation requirement has the result that a person may not set up a nondeductible IRA with one IRA custodian and have other taxable IRAs with other IRA custodians or the same custodian for that matter.

It is understandable why an IRA accountholder wants to make such a rollover, if permissible. With respect to the traditional IRA, the earnings associated with the nondeductible basis will be taxable upon distribution, whereas the earnings associated with a Roth will not be taxable.

Some accountholders seem to believe they can roll over just their nondeductible account balance. They cannot. Adverse tax consequences would certainly result from a misunderstanding of the rules.

For example, Heidi McClain, age 49, has three IRAs with three different financial institutions. Her aggregated account balance is $50,000. Her nondeductible contribution basis is $10,000.

If she rolls over the entire $50,000, her tax result would be: to include $10,000 (taxable portion of $40,000/4) in income for 1998, 1999, 2000 and 2001. The basis amount of $10,000 would not be taxed. Once rolled over, the entire $50,000 would start to accumulate earnings which would never be taxed if the special rules are satisfied.

If she would choose to roll over only $10,000, her tax result would be: $2,000 would be the return of her basis (remaining balance of $8,000) and would not be taxable and she would include $2,000 (taxable portion $8,000/4) in income for 1998, 1999, 2000 and 2001. She would have a remaining balance of $40,000 in her traditional IRA with the following breakdown—a nontaxable basis of $8,000 and a taxable portion of $32,000.

If she would choose to roll over only $20,000, her tax result would be: $4,000 would be the return of her basis (remaining balance of $6,000) and would not be taxable and she would include $4,000 (taxable portion $16,000/4) in income for 1998, 1999, 2000 and 2001. She would have a remaining balance of $30,000 in her traditional IRA with the following breakdown—a nontaxable basis of $6,000 and a taxable portion of $24,000.

Conclusion. An IRA accountholder may not roll over just the nondeductible account balance of his or her traditional IRA. The law does not permit it. If an accountholder rolls over only a portion of his or her traditional IRA, then he or she will be required to complete and file the Form 8606 so the determination of what portion of the basis was rolled over and what portion remains within the traditional IRA may be made.

Planning Tips for Substantially Equal Periodic Payments—

As you know, an IRA accountholder who is not yet age 59 1/2 will not be assessed the 10% excise tax imposed under Code section 72(t) if he or she qualifies for the use of one of the eight exceptions which exist for IRAs. One of those exceptions is for substantially equal periodic payments.

The IRS in Notice 89-25 described three distribution methods which would qualify as safe harbor methods for determining the amount of the substantially equal periodic payments. The methods were: (1) the "70 1/2" method; (2) the amortization method and (3) the annuity factor method.

Thought #1. With the amortization or annuity factor the general rule has been that the amount once determined could not be changed unless that change complied with the later of the "age 59 1/2" or "in effect for five years" rule. The IRS has now authorized a new limited exception to this rule. The IRS issued PLR 9723035 in 1997. In this PLR the IRS states that it is permissible for the accountholder to adopt a substantially equal periodic payment schedule which allows the annual amount to be increased by a cost of living adjustment factor. This COLA factor must be defined just as the amortization or annuity formula must be defined. Individuals who now would set up a substantially equal periodic payment schedule will wish to include a COLA adjustment factor.

Thought #2. The standard "70 1/2" method has been presumably the least used of the three methods. The primary reasons —it initially allowed the least amount to be distributed and secondly it was more of an administrative hassle since a new calculation had to be done each year to determine the payout amount.

However, there can be a major advantage to having to recalculate the amount annually under the "70 1/2" method. Under this method the annual payment amount can increase dramatically. For example, a person establishes the substantially equal periodic payment schedule at age 50 when his or her account balance is $100,000. Because of very wise investment choices, the fair market value of the IRA increases to $150,000 within four years. If the "70 1/2" method is being used, a larger payout must be made to the IRA accountholder. This may or may not be desirable. There would be no change in the payment amount if either the amortization or annuity-factor method had been elected.

If an accountholder would like his or her payout amount to be larger then what it initially starts out at, the accountholder may well wish to elect the "70 1/2" method and hope the investments perform very well in order to justify a late payout in later years.

Thought #3. A person with only one IRA may well wish to split this one IRA into two IRAs before he or she establishes a substantially equal periodic payment schedule. For example, a person age 52 with an IRA balance of $300,000 only wishes to have paid to her the annual amount of $13,000. She only needs a balance of $175,000 to generate this payment. There is no reason to tie up the excess of $125,000. If funds are ever needed, take them from the IRA which has not had the schedule established. Then the 10% excise tax will only be assessed on those distributions and not all prior distributions as happens when someone modifies an established schedule by taking more before the rules permit.

Failed IRA — Nonqualifying Trustee

A fundamental requirement of the IRA laws is that an IRA must have a trustee or custodian which is a bank, a federally insured credit union, a savings and loan association or an entity approved by the IRS to act as the trustee or custodian. Based upon the IRS regulation which governs this approval process, it would be very rare if the IRS would ever approve an individual to serve as an IRA trustee or custodian.

From time to time court cases arise which illustrate that some people fail to understand this rule or choose to ignore it. Those who ignore it do so at their own tax peril.

Sometimes individuals think that they can act as their own trustees because they must think that there cannot be that much difference between being a trustee and exercising a contractual right to self-direct his or her IRA's trustee what to invest in. Other individuals are told by a third party that they are an IRA trustee and can certainly establish and fund an IRA for them.

The tax results in either situation can be harsh.

The tax court case of School v. Commissioner, US TC No. 426596, 1/12/98 is an example of the second situation—a person was told by a third party that he or she qualified as an IRA trustee when this was not the case.

Facts. The taxpayers had funds within an IRA with an approved IRA trustee. They withdrew these funds. Allegedly, a Mr. Thomson had sought approval from the IRS to become an IRA trustee. Such approval had not been obtained. The taxpayers had rolled over their IRA distributions to one of Mr. Thomson's alleged IRAs. Their alleged IRA funds were invested into a security which was designed around the concept of bus stop shelter programs.

The court ruled that the entire amount withdrawn from their IRAs with the other institution was fully taxable (and was also subject to the 10% excise tax) because a valid rollover did not occur since a valid IRA cannot be established without having an authorized IRA trustee.

The court found that the substantial compliance exception as authorized by the tax court in Wood v. Commissioner did not apply as there had not been substantial compliance.

Summary. This case presents the concept that it is the taxpayer who has the burden of making sure that a party which proposes to act as the IRA trustee for his or her IRA actually has the authority to so act. PD

✓✓✓ Check It Out ✓✓✓

Situation/Question: We had a QP/Keogh participant die recently on January 7, 1998. He had a balance of $37,000. He had designated his son and his daughter as his beneficiaries. Each was to receive 50%. Both beneficiaries have informed me that they wish to have their 50% share distributed to them. Must they have 20% withheld from their distribution for federal income tax purposes?

✓ Answer: No. Mandatory withholding of 20% applies only if the distribution is an eligible rollover distribution. Nonspouse beneficiaries are not eligible to roll over funds from a qualified plan to an IRA.

Situation/Question: A bank has an IRA Accountholder, Davis Pine II. He has an IRA balance of $75,000. He was age 70 1/2 in 1997. He is now age 71. His life-expectancy factor for 1998 is 15. His required minimum distribution is $5,000 for 1998. Mr. Pine has been told by his broker that he certainly may roll over the entire $75,000 to his new Roth IRA which he has established with his broker. Is he eligible to roll over $70,000 or $75,000 to his Roth IRA? The bank told him $70,000, but the broker is asking for some authority.

✓ Answer. The maximum amount he may roll over to his Roth IRA from his traditional IRA is $70,000.

Discussion. The rules for Roth IRAs are found in Code section 408A. This is a new section added by the Taxpayer Relief Act of 1997. The rules for traditional IRAs are found in Code section 408.

Code section 408A(a) is extremely important for administering Roth IRAs. It reads, "Except as provided in this section a Roth IRA shall be treated for purposes of this title in the same manner as an individual retirement plan." We construe this to mean — all the normal rules set forth in Code section 408 also apply to a Roth IRA unless changed by a provision found in section 408A.

Code section 408A(e) states, "but only if such rollover contribution meets the requirements of section 408(d)(3)."

Code section 408(d)(3) sets forth the general rollover rules (e.g. the 60-day rule, the once per 12-month rule, the rule that a beneficiary may not roll over an inherited IRA, etc.) Subsection (E) states that a required minimum distribution is not authorized to be rolled over.

Section 408A does not contain any provision which states that the rules of subsection (E) do not apply to the Roth IRA. It does not appear that this omission was a mistake. There is very clearly a statement that any rollover from a traditional IRA to a Roth will not count as a rollover for purposes of the rule that allows a person only one rollover per year. If Congress had wanted a person to be able to roll over his or her required distribution, Congress would have included a provision in Section 408A to override the rule found in Code section 408(d)(3). They did not. Therefore, such a rollover is not permissible.

If a person chooses to roll over his or her RMD, this amount would be an excess contribution to a Roth IRA and the 6% excise tax would be owed unless corrected. 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.

IRS Form 1099-R (Instructions on Reverse Side)

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PAYER'S name, street address, city, state, and ZIP code	1 Gross distribution $ 2a Taxable amount $	OMB No. 1545-0119 **1998** Form **1099-R**		**Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.**
	2b Taxable amount not determined ☐	Total distribution ☐		**Copy A For Internal Revenue Service Center** **File with Form 1096.**
PAYER'S Federal identification number | RECIPIENT'S identification number	3 Capital gain (included in box 2a) $	4 Federal income tax withheld $		
RECIPIENT'S name	5 Employee contributions or insurance premiums $	6 Net unrealized appreciation in employer's securities $		For Paperwork Reduction Act Notice and instructions for completing this form, see the **1998 Instructions for Forms 1099, 1098, 5498, and W-2G.**
Street address (including apt. no.)	7 Distribution code | IRA/ SEP/ SIMPLE ☐	8 Other $	%	
City, state, and ZIP code	9a Your percentage of total distribution %	9b Total employee contributions $		
Account number (optional)	10 State tax withheld $ $	11 State/Payer's state no.		12 State distribution $ $
	13 Local tax withheld $ $	14 Name of locality		15 Local distribution $ $

Form **1099-R** Cat. No. 14436Q Department of the Treasury - Internal Revenue Service

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