THE Pension Digest

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IRS Issues the 1998 Instructions for Forms 1099, 1098, 5498 and W-2G

The IRS issued the 1998 instructions for Forms 1099-R and 5498 in mid-April. These instructions have been changed to accommodate the new Roth and Ed IRAs.

In last month's newsletter we indicated that the IRS had issued the 1998 forms and the instructions to be furnished the participant. These "participant" instructions, of course, are helpful, but they are not as helpful as the instructions which the IRS furnishes the preparer of the forms (i.e. the IRA custodian).

This article has three sections. Section I will discuss the new instructions related to the Form 1099-R. Section II will discuss the new instructions related to the Form 5498. Section III will set forth those provisions within the instructions which we believe are of most interest to you.

Section I—The Form 1099-R

We set forth our summary of the IRS' instructions for completing the Form 1099-R and we then set forth our comments about these instructions.

1. IRS Instructions for Roth and Ed IRA Distributions. For most Roth IRA distributions and Ed IRA distributions, you are to report the gross distribution in box 1. Box 2a should be left blank, and you should mark the "taxable amount not determined" box in 2b. Use Code J, K or M as appropriate in box 7. You may also use Code 1 or 2 with the J and K codes. You may not use code 7 with a J, K or M.

An exception exists when the IRS does not want you to leave box 2a blank. If the distribution is a distribution of a "current-year" excess contribution, then you are to insert the gross amount (i.e. contribution amount plus earnings) in box 1 and the earnings portion in box 2a. As with a withdrawal of an excess contribution from a traditional IRA, you will use either the Code 8 or P.

1A. Our Comments. The IRS' instructions about leaving box 2a blank makes sense. It will be the individual's responsibility to explain what portion of his or her distribution is the return of basis and what portion is taxable, if any. Most likely the individual will have to complete a form similar to the current Form 8606. Note that the IRS says that Codes 1 and 2 may be used in combination with the J or K, but that a Code 7 must not be used. Also note that nothing is said about Codes 3, 4 and 5. Our guess is that you could use Codes 3, 4, or 5 in combination with J or K. Note that you do not ever use any numerical code in combination with the M for a distribution from an Ed IRA

2. IRS Instructions for a Conversion of a Traditional IRA to a Roth IRA. The instructions state that you are to use a Code 2 in box 7 if the individual is under age 59 1/2, or Code 7 if the individual is at least 59 1/2. You are not to use Codes J or K. You are also to mark the IRA/SEP/SIMPLE box in box 7 as the distribution is coming from either an IRA or SEP.

2A. Our Comments. The IRS has surprised us—they want a Code 2 or 7 used rather than a Code 1 or 7.

There are some situations where we see the code 2/7 approach as working but we also see it not working for all situations.

If the Roth conversion occurs within the same financial institution, then we agree with the IRS approach to use a Code 2. Remember that Code 2 is to be used when there is a known exception to the 10% excise tax of Code section 72(t). And remember that rolling over a distribution from a traditional to a Roth is a known exception to the 10% excise tax.

Where we disagree with the IRS is if the IRA accountholder withdraws the funds from your institution and instructs you that he or she intends to do a Roth rollover. The instructions as written say to use a Code 2. But how do you really know if such funds will be rolled over into a Roth IRA? You may if you sent the check to the other institution, but you do not, if you make the check out to the individual. You will recall that prior to 1992, the IRS used to use Code 2 to indicate that a person intended to roll over his or her distribution. The IRS finally scrapped this code because they realized that intending to roll over a distribution and actually doing the rollover are not the same.

Even though we disagree with some of the IRS' instructions, we suggest you follow the IRS' instructions until they decide to change them.

3. IRS Instructions for Distributions from a Traditional IRA. For most distributions you are to report the gross distribution amount in both box 1 (gross amount) and box 2a (taxable amount). The reason is— you are not required to compute the taxable portion or the basis portion of a distribution. You may (but are not required to) mark the "taxable amount not determined" box in box 2b.

A number of exceptions exist when the IRS wants you to insert an amount other than the gross distribution amount in box 2a. First, for a distribution of a current-year excess contribution plus earnings, the IRS wants you to insert the earnings amount in box 2a. Second, for a distribution of a prior year's excess contribution, the IRS wants you to insert a zero in box 2a. Third, you are to insert a zero if you

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have sent a check from an accountholder's conduit IRA directly to a qualified plan. This is not really a direct rollover, but it is similar that the IRS has now instructed you to use a Code H and insert a zero in box 2a.

3A. Our Comments. The IRS instructions for the most part are quite logical and consistent with the exception of how you are to report when funds are rolled over from a conduit IRA to a qualified plan. The IRS is starting to be very imprecise in what they mean when they use the terms, "direct rollover" or "transfer." If possible, we suggest that you continue to be precise and do not become as sloppy as the IRS appears to have become.

4. IRS Instructions Regarding Use of Code 1 for a Specific Situation. The IRS instructions now make clear that if an IRA accountholder establishes a periodic payment schedule and modifies it before the law permits, then you are to use a Code 1 for the distributions occurring in the year of modification. The IRS' instruction reads:

> **Note:** *Even if the employee/taxpayer is 59 1/2 or over, use Code 1 if a series of substantially equal periodic payments was modified within 5 years of the date of the first payment (within the meaning of section 72(q)(3) or (t)(4)). For example, Mr. B began receiving payments that qualified for the exception for part of a series of substantially equal periodic payments under section 72(t)(2)(A)(iv) when he was 57. When he was 61, Mr. B substantially modified the payments. Because the payments were modified within 5 years, use Code 1 in the year the payments were modified, even though Mr. B is over 59 1/2.*

4A. Our Comments. This instruction is understandable. If the schedule is impermissibly changed, then the Code 2 is not the proper code even if the person is now age 59 1/2 or older. The IRS makes it clear that a Code 1 might be required to be used even if the IRA accountholder is older than age 59 1/2. And this is correct. Note that the IRS does not require any correcting of prior-year forms. Apparently, the IRS will determine that when a 2 is being used and then is changed to a 1 in a subsequent year, that additional taxes will be owing.

5. IRS Instructions for Use of Proper Distribution Codes for Box 7. You are to file only one Form 1099-R from an IRA in which may be comprised of multiple investments unless you must enter different distribution codes in box 7. Further, you do not have to file a separate Form 1099-R for each distribution under the plan. File only one Form 1099-R for multiple distributions from an IRA that are paid in one year to one recipient and that all require the same distribution code in box 7.

You must enter the proper numeric code except when it is required to use the alpha code: H, J, K, M, P or S. When applicable, you may insert both an alpha and a numeric code. And in three situations, you may insert two numeric codes (8/1, 8/2 and 8/4).

5A. Our Comments. The IRS instructions are murky as to whether or not an IRA custodian could prepare a separate Form 1099-R for each distribution. We don't think the IRS wants a separate form for each distribution, but the first sentence above says one thing and the second sentence implies the opposite. We recommend that you prepare just one Form 1099-R per recipient as long as the distribution codes are the same. We also believe the IRS would prefer you to insert two codes when applicable. For example, when using a Code P or 8 for the withdrawal of a current-year excess, you also enter Code 1.

6. IRS Instructions for "Correcting" Erroneous Rollovers. This is new for 1998. This is an important change. The IRS instructions contain the following statement with respect to the Form 1099-R. Be aware that the IRS also has some new instructions with respect to correcting the Form 5498 as to an erroneous rollover. You should review the Form 5498 portion of this article for that discussion.

> **Corrected Form 1099-R.** If you filed a Form 1099-R with the IRS and later discover that there is an error on it, you must correct it as soon as possible. For example, if you transmit a direct rollover and file a Form 1099-R with the IRS reporting that none of the direct rollover is taxable by entering 0 (zero) in box 2a, and you then discover that part of the direct rollover consists of required minimum distributions under section 401(a)(9), you must file a correct Form 1099-R. See part I under **General Instructions** on page 9.

6A. Our Comments. The IRS has finally addressed in their instructions a paying entity's duty to correct a previously issued Form 1099-R when an error has occurred as to the dollar amount eligible to be rolled over. The IRS is saying that the paying entity must correct a previously issued Form 1099-R if it has information to know that part of the funds did not qualify to be rolled over.

The IRS has chosen to discuss only one specific situation—an error occurred with respect to a direct rollover from a qualified plan to an IRA because there was an impermissible rollover of a required minimum distribution. The Form 1099-R which was originally prepared showed a taxable amount as "0" because the distribution code was a G. Note that the IRS says it must be corrected, but there is no discussion as to what specific corrections must be made.

Let's assume that the amount of $26,425 is directly rolled over, but this includes the required minimum distribution amount of $3,000.

To make the necessary corrections, we believe the following should happen: (1) correct the original Form 1099-R by showing the proper amount in box 1 (i.e. the amount as reduced by the RMD amount) or $23,425 and (2) prepare a new Form 1099-R for the RMD amount of $3,000 and insert the $3,000 in boxes 1 and 2a and with a distribution Code 7.

Question: In some situations, might an IRA custodian be required to correct a previously issued Form 1099-R because of an error which has occurred with respect to a rollover? Based upon the 1998 IRA instructions, we believe the answer is a definite "yes."

7. IRS Instructions for Withholding. Do not withhold on a distribution from an Education IRA. You must withhold from a distribution from a traditional IRA or Roth IRA unless the recipient instructs you that he or she does not want withholding. You are allowed to assume that the entire amount of an IRA distribution is taxable, but you may not assume this for the withdrawal of excess contributions. The IRS makes clear that the mandatory withholding rate of 20% does not apply to IRA distributions.

7A. Our Comments. We agree with the IRS. Be aware that the IRS is following the logical approach that withholding applies only if the distribution is taxable. Thus, if you know the distribution is not taxable, then withholding does not apply to that extent. Most likely the IRS simply forgot to include the movement of funds from a conduit IRA to a qualified plan as not being subject to withholding.

8. IRS Instructions for Use of Code S. Use Code S only if the distribution is from a SIMPLE-IRA in the first two years, the person has not yet reached age 59 1/2, and none of the exceptions under section 72(t) are known to apply. The two-year period begins on the day contributions are first deposited in the person's SIMPLE-IRA. Do not use Code S if Code 3 or 4 applies.

8A. Our Comments. We agree with the IRS. Please note that if one of the exceptions to the 10% tax applies, then Code S is not be used.

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Section II—The Form 5498

We set forth our summary of the new IRS' instructions or the most important instructions for completing the Form 5498 and our comments on these instructions. Not much has changed. The new boxes were discussed in last month's issue.

1. IRS Instructions for Certain SIMPLE-IRA Transfers or Rollovers and the Larger Issue of Erroneous Rollovers. The instructions state: "If a rollover or trustee-to-trustee transfer is made from a SIMPLE-IRA to an IRA which is not a SIMPLE-IRA and the trustee has adequately substantiated information that the participant has not satisfied the two-year period described in section 72(t)(6), report the amount as a regular contribution in box 1 even if the amount exceeds $2,000.

1A. Our Comments. The IRS believes a rollover or transfer cannot be made from a SIMPLE-IRA to a nonSIMPLE-IRA until a two-year holding period has been satisfied.

The IRS is saying that if you have knowledge that the two-year requirement has not been met, then you must report this contribution as a regular contribution and not as a rollover or a nonreportable transfer.

Although the IRS instructions do not discuss any other erroneous rollover situations other than the SIMPLE situation, the IRS' position appears to be that the amount in box 2 must only be the permissible rollover amount. Thus, in some situations a corrected Form 5498 would need to be prepared.

For example, in the erroneous direct rollover example discussed under the Form 1099-R section, originally $26,245 was rolled over. It was then discovered that $3,000 was not eligible to be rolled over. Originally, the receiving IRA custodian would have recorded a $26,245 rollover and would have reported it in box 2 of the Form 5498. Once you know of the error, the IRS now requires that you correct your entries. You would now show the rollover amount as $23,245 and you would have a regular contribution of $3,000. Obviously, this is an excess and would need to be corrected.

2. IRS Instructions for the Death Situation. The instructions state a simple warning: you should not report the same fair market value for the decedent and a beneficiary.

2A. Our Comments. This statement is correct because the decedent's fair market value is determined at his or her time of death and the fair market value for a beneficiary is as of December 31. Only if the death occurred on December 31 at the end of the day would the figures be the same.

Section III—General IRS Instructions

Set forth below are those IRS instructions which we believe are important for any IRA custodian to know.

1. FORM 1099-R CHANGES

New Codes. Because of recent legislation that created Roth IRAs and Education IRAs, three new distribution codes were added to box 7 of Form 1099-R. Distributions from Pension, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc. The new codes are:

J - Distribution from a Roth IRA in first 5 years

K - Distribution from a 1998 Roth Conversion IRA in first 5 years

M - Distribution from an Education IRA

Annuity Payments. If you made annuity payments from a qualified plan and the annuity starting date is after November 18, 1996, you must use the new simplified method to figure the taxable amount. See Notice 98-2, 1998-2 I.R.B. 22, and Form 1099-R on page 29.

2. FORM 5498 CHANGES

Because of recent legislation, the 1998 Form 5498 was retitled IRA Contribution Information, and several new boxes were added to the form to report contributions to Roth IRAs and Education IRAs (Ed IRAs). In addition, some box titles were changed and other boxes were renumbered and/or relocated. The 1998 boxes are as follows:

Box 1 - IRA contributions (other than amounts in boxes 2, 3, and 7-10)

Box 2 - Rollover contributions

Box 3 - Roth conversion amount

Box 4 - Fair market value of account

Box 5 - Life insurance cost included in box 1

Box 6 - Check boxes for: IRA, SEP, SIMPLE, Roth IRA, Roth Conversion, Ed IRA

Box 7 - SEP contributions

Box 8 - SIMPLE contributions

Box 9 - Roth IRA contributions

Box 10 - Ed IRA contributions

For Ed IRAs only, the due date for furnishing the statement to the participant (Copy B) is February 1, 1999. For all other IRAs, the due date is June 1, 1999. See Form 5498 on page 39.

3. Information Reporting Call Site. The IRS operates a centralized call site to answer questions about reporting on information returns—Forms 1096, 1098, 1099, 5498, W-2, W-2G, and W-3. If you have questions about reporting on any of these forms, you may call 304-263-8700. The hours of operation are Monday through Friday from 8:30 a.m to 4:30 p.m. eastern time.

4. REMINDER.—Substitute Statements to Recipients. If you are not using the official IRS form (generally Copy B) to furnish statements to recipients, be sure your substitute statements comply with the rules in **Pub. 1179**, Rules and Specifications for Private Printing of Substitute Forms 1096, 1098, 1099, 5498, and W-2G. Pub. 1179, which is revised annually, is a revenue procedure that explains the requirements for format and content of substitute statements to recipients. If you are using a substitute form to furnish information to recipients, it must comply with the requirements in Pub. 1178.

Caution: *All substitute statements to recipients must contain the tax year, form number, and form name prominently displayed together in one area of the statement. For example, they could be shown in the upper right part of the statement.*

5. Distributions from pension plans and IRAs are not subject to backup withholding.

6. The penalties of Code section 6721 and 6722 apply to Form 1099-R (but not to Ed IRA distributions).

7. The penalties under section 6721 and 6722 do not apply to Forms 5498, 5498-MSA, 1099-R for Ed IRAs and 1099-MSAs.

8. Mergers. If two corporations merge, and the surviving corporation becomes the owner of all the assets and assumes all the liabilities of the absorbed corporation, the reporting requirements explained in this publication will be met if the surviving corporation files Forms 1098, 1099, 5498, and/or W-2G for reportable payments of both corporations. See Rev. Rul. 69-556, 1969-2 C.B. 242.

For information on filing Form 1099-INT for a successor/predecessor corporation, see **Form 1099-INT** on page 20.

9. Telephone Numbers. You are required to include the telephone number of a person to contact on certain statements to recipients. You must include the telephone number on the following statements to recipients: W-2G, 1098, 1098-E, 1098-T, 1099-A, 1099-B, 1099-DIV, 1099-G (excluding state and local income tax refunds), 1099-INT, 1099-LTC, 1099-MISC (excluding fishing boat proceeds), 1099-OID, 1099-PATR, and 1099-S. Payers are permitted to include the telephone number in any conspicuous place on the statements. This number must provide direct access to an individual who can answer questions about the statement. Although not required, payers reporting on other Forms 1099 and 5498 are encouraged to furnish telephone numbers. The telephone number is not required on Copy A of paper

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forms nor on magnetic media filed with the IRS.

10. Keeping Copies. Generally, keep ›ies of information returns you filed with ᴜɪe IRS or have the ability to reconstruct the data for at least 3 years from the due date of the returns. If backup withholding was imposed and for Form 1099-C, keep copies of information returns for 4 years.

11. Statement Mailing Requirements. The statement mailing requirements explained earlier do not apply to statements to recipients for information reported on Forms 1098, 1098-E, 1098-T, 1099-A, 1099-B, 1099-C, 1099-G, 1099-LTC, 1099-MISC (except for royalties), 1099-MSA, 1099-R, 5498, 5498-MSA, W-2G, 1099-DIV for section 404(k) dividends only, and 1099-INT for interest reportable in the course of your trade or business under section 6041 only. You may combine the statements with other reports or financial or commercial notices, or expand them to include other information of interest to the recipient. Be sure that all copies of the forms are legible.

12. Deadlines. Trustees or issuers of IRAs or SEPs must furnish participants with a statement of the value of the participant's account by February 1, 1999. **Education IRA contribution information must also › furnished to the participant by ›bruary 1, 1999.** Traditional IRA, Roth IRA, SEP, or SIMPLE contribution information must be furnished to the participant by June 1, 1999.

Trustees of a SIMPLE must furnish a statement of the account balance and the account activity during the year by February 1, 1999.

For real estate transactions, you may furnish the statement to the transferor at closing or by mail on or before February 1,1999.

Filers of Form 1099-G who report state or local income tax refunds, credits, or offsets must furnish the statements to recipients during January 1999.

You will meet the requirement to furnish the statement if it is properly addressed and mailed on or before the due date. If the regular due date falls on a Saturday, Sunday, or legal holiday, the due date is the next business day. A business day is any day that is not a Saturday, Sunday, or legal holiday.

13. Distributions other than Cash. You must show the fair market value of the property at the time of distribution.

Note that time of distribution is not necessarily the same value as of the end of the day.

✓✓✓ Check It Out ✓✓✓

Situation/Question: We have IRA accountholders who have multiple IRA plan agreements because they have a "regular" IRA as well as one or more conduit IRAs. For example, Laura Wang has a regular IRA and two conduit IRAs. In addition, she inherited her father's IRA. The regular IRA is comprised of four (4) time deposits, each conduit IRA has one time deposit and the inherited IRA is comprised of three time deposits.

We know that the IRA reporting rules for Form 5498 do not allow us to aggregate the "numbers" and prepare just one Form 5498 for these four IRAs. We know that at a minimum we must prepare at least four Form 5498s. However, because of computer limitations in earlier years, we never identified the time deposits associated with a particular plan agreement. Therefore, we prepare a Form 5498 for each time deposit. We really can't go wrong if we prepare a Form 5498 for each time deposit, can we? For example, with respect to Laura Wang, we will prepare nine (9) Form 5498's. Is this permissible? Could we possibly be fined by the IRS for preparing five "incorrect" Form 5498s?

✓ **Discussion/Answer.** The instructions which the IRS has written for 1997 and 1998 do not expressly address this situation. Set forth below are the statements within the instructions which pertain:

1. "An IRA includes all IRA investments under one IRA plan. It is not necessary to file a Form 5498 for each investment under one plan. For example, if a participant has three CDs under one plan, only one Form 5498 is required for all contributions and the fair market of the CDs under the plan. However, if an individual has established more than one IRA plan with the same trustee, a separate Form 5498 must be filed for each plan." (Emphasis added.)

2. "An IRA holder must be able to identify the source of each IRA he or she holds for purposes of figuring the taxation of a distribution from an IRA."

The instructions clearly state that it is not permissible to prepare just one Form 5498 in a multiple IRA plan agreement situation. However, the underlined portion of the instructions seem to imply that it would be permissible to prepare a Form 5498 for each investment, but not mandatory. Therefore, the IRS should not impose fines when an IRA custodian prepares a Form 5498 for each investment under the theory that the additional Form 5498's would be considered to be incorrect forms. Having said this, we believe the better administrative approach is to prepare a Form 5498 for each plan agreement and not for each investment. If you don't have this capability, you want to work towards it as soon as possible. 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.

14. Filings for de minimis amounts. The IRS understands that you are not required to report payments smaller than the minimum described for a particular form. The IRS, however, states that you may prefer, for economy and your own convenience, to file copies for all payments. The IRS encourages this.

Summary

Now that the IRS has issued their instructions for the 1998 Forms 1099-R and Form 5498, you can work with your personnel and data processing entities to perform the reporting tasks as the IRS has instructed. Because the IRS has had to contemplate many new law changes, do not be surprised to see the IRS make some changes in two to four months. PD

Status of the Technical Corrections Bill

ON HOLD as the U.S. Congress considers taxpayer testimony informing them that the IRS frequently abuses the taxpayer by using excessively the legal sledgehammers which they have under the law.

We will keep you informed of the technical correction bill(s) as there will be action before year-end. Remember, many of these changes may well be retroactive and will be effective as of January 1, 1998. PD