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## The 1998 Form 8606

The purpose of this article is to discuss in detail the 1998 Form 8606. This form is completed by an accountholder/taxpayer and not the IRA custodian/trustee. The reason this article discusses Form 8606 is that it indicates how the IRS plans to gather the information which is necessary to determine the tax consequences associated with Roth IRA and Education IRA transactions. The principal transactions are: contributions, recharacterizations, distributions, and hopefully, the realization of earnings and not losses.

The 1998 Form 8606 is an insert.

We believe there is a fairly important error on the form. This error is discussed later in the article.

The title of this form is "Nondeductible IRAs." There should be a new title as the 1998 form has been changed to handle much more than just "nondeductible" transactions: (1) conversion from traditional or SIMPLE-IRAs to Roth IRAs; (2) determining the taxable portion of distributions from Roth IRAs; (3) showing the recharacterization of a conversion; (4) determining the taxable portion of distributions from Ed IRAs; and (5) showing the recharacterization of IRA contributions involving Roth contributions.

Note—it is somewhat surprising, but the IRS has apparently adopted the approach to not require each Roth IRA accountholder or Ed IRA accountholder to file the Form 8606 in order to determine the year-end basis. There are worksheets included in the form to be used to determine the accountholder's basis, but the Roth and Ed IRA accountholder will not be required to file the form only to report a change in their basis by the making of a contribution.

**Who is required to file the 1998 Form 8606?**

An accountholder must file Form 8606 if any of the following apply:

1. (S)he made nondeductible contributions to a traditional IRA for 1998;

2. (S)he received distributions from a traditional IRA in 1998 and have ever made nondeductible contributions to a traditional IRA;

3. (S)he converted part or all of the assets in a traditional or SIMPLE-IRA to a Roth IRA during 1998;

4. (S)he recharacterized amounts that were converted to a Roth IRA;

5. (S)he received distributions from a Roth IRA in 1998;

6. (S)he has a recharacterization involving a Roth IRA contribution; or

7. (S)he is the designated beneficiary of an Ed IRA and received distributions from an Ed IRA in 1998.

An accountholder or an Ed IRA designated beneficiary can be required to file the Form 8606 even if he or she is not required to file a Form 1040, 1040A, or 1040NR. There is a signature section on page two of the form. The individual is to file the Form 8606 at the same IRS office the person would have otherwise filed his or her Form 1040, 1040A, or 1040NR.

**Part I of the Form (Traditional IRAs—Nondeductible Contributions, Distributions and Basis)**

This part of the form has not changed. The taxpayer must complete this part to: (1) report any nondeductible contributions to a traditional IRA; (2) figure the "new" basis in the taxpayer's traditional IRAs; and (3) figure the taxable part of any distributions received in 1998 from traditional IRAs if there had ever been a nondeductible contribution to a traditional IRA.

**Special Instruction.** If you recharacterized a conversion contribution from a Roth IRA back to a traditional IRA, or if you recharacterized contributions to or from a traditional IRA, the taxpayer is to complete Part I in a way that reflects his or

## 1999 COLAs for MSAs



The IRS has recently released various cost-of-living adjustments for 1999. One of these adjustments applies to medical savings accounts.

In order to be able to claim a deduction for contributions to a medical savings account, there must be a qualifying "high deductible health plan."

If a taxpayer has self-only coverage, a high-deductible health plan means a health plan which: (1) has an annual deductible that is not less than \$1,550;

(2) has an annual deductible that is not more than \$2,300; and (3) under which the annual out-of-pocket expenses required to be paid (other than for premiums) for covered benefits does not exceed \$3,050.

If a taxpayer has family coverage, a high-deductible health plan means a health plan which: (1) has an annual deductible that is not less than \$3,050; (2) has an annual deductible that is not more than \$4,600; and (3) under which the annual out-of-pocket expenses required to be paid (other than for premiums) for covered benefits does not exceed \$5,600.

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her traditional IRA after the recharacterization.

### Part II of the Form—Conversion from Traditional IRAs to Roth IRAs

This part of the form is new. The taxpayer reports here the amount he or she converted to a Roth IRA, the taxable portion of such conversion, and the amount of any recharacterization involving Roth conversion contributions. The law provides that the taxpayer will use the four-year spread method unless he or she elects to include the entire distribution in income in 1998. There is a box to be checked on line 17 if the entire distribution is to be taxed.

On line 14a, insert all amounts originally converted. On line 14b, insert that portion of the amount converted which was recharacterized.

### Part III of the Form—Distributions from Roth IRAs

This part of the form is new. The taxpayer reports here the amount of distributions from his or her Roth IRAs with the purpose of determining what portion of the distribution, if any, must be included in income, and what portion of the distribution, if any, is subject to the 10% additional tax.

Before discussing the taxation of a distribution from a Roth IRA, the completion of lines 19a, 19b, and 19c need to be explained. These lines deal with recharacterizations and need to be completed by a taxpayer who has had a recharacterization even if there have been no distributions from the Roth IRA.

Line 19a is completed with the amount of the "original" annual Roth contributions as adjusted for any withdrawn excess contributions.

The completion of lines 19b and 19c depends upon whether the recharacterization is to a Roth IRA or to a traditional IRA. If the original contribution of \$2,000 was to a traditional IRA and it is now recharacterized to a Roth IRA when the value is \$2,300, then line 19a is completed with a zero and lines 19b and 19c are completed with \$2,000 (not \$2,300). If the original contribution of \$2,000 was to a Roth IRA and it is now recharacterized to a traditional IRA when the value is \$2,400, then line 19a is completed with \$2,000 and line 19b is completed with (\$2,000) and line 19c is completed with zero.

Note that the instructions state that the taxpayer will receive a Form 1099-R for each conversion and a Form 1099-R for each reconversion. The taxpayer is to include the total of the gross distribution amounts on line 15a of Form 1040 or a similar line on Forms 1040A and 1040NR. The taxpayer is also to

attach a note explaining the specific details of the recharacterization.

### Discussion of Taxation of a Distribution

As you will recall, the law defines the order of distributions for taxation purposes: (1) annual contributions; (2) conversion contributions in order of time, and (3) earnings.

Line 26 reflects the taxable amount of the distribution from the Roth IRA. Remember that when the four-year spread method applies and the account holder takes out a distribution before the end of the four-year period, amounts that otherwise would be deferred are accelerated into income. Consider the following example. Robert Taylor converts \$10,000 from his traditional IRA to a Roth IRA on 7-10-98. He also makes a \$2,000 contribution on 8-10-98. Because of unforeseen financial difficulties, he withdraws \$5,000 from his Roth IRA on 12-10-98. Part II and Part III of the form would be completed as shown below.

Observe that he includes \$2,500 in income on line 15b of the Form 1040 from line 17 of Part II, and he includes \$3,000 on line 15B of the Form 1040 from line 26. Thus, \$5,500 is included in income rather than \$2,500 because of the distribution which occurred in 1998.

Also observe the special note at the end of line 26. It reads as follows:

"If you have an amount on line 22 or 25, you will be subject to an additional 10% tax. See page 6 for details."

The instructions for lines 22 and 25—additional 10% tax read as follows:

"If you have an amount on line 22, you will be subject to an additional 10% tax. To determine the amount subject to the additional tax, first subtract line 15 from line 23. If the result is greater than 0, add it to the amount on line 22 and include the sum on line 1 of Form 5329. If the result is not greater than 0, include the amount from line 22 of Form 8606 on line 1 of Form 5329. Disregard the related instructions in the Form 5329 instructions."

### The Error

Not every taxpayer will owe the 10% additional tax. The IRS, in the Roth IRA proposed regulation, makes it very clear that the other exceptions of Code section 72(t) may apply to a subsequent distribution from a Roth IRA. For example, assume that Robert Taylor was age 61 at the time of his conversion. He will

*Continued on page 3*

## Form 8606

### Part II Conversions from Traditional IRAs to Roth IRAs

**Before you begin**, see page 5 if: (1) your filing status is married filing separately, (2) your modified AGI is more than \$100,000, (3) you converted only part of your traditional IRAs to Roth IRAs, or (4) you received any distributions (withdrawals) from traditional IRAs during 1998.

14a	Enter the total amount of distributions from traditional IRAs during 1998 that were converted to Roth IRAs . . . . .	14a	10,000	--
b	Recharacterizations. See page 3 . . . . .	14b	0	--
c	Subtract line 14b from line 14a . . . . .	14c	10,000	--
15	Enter your basis in the amount you entered on line 14c. See pages 5 and 6 . . . . .	15	0	--
16	<b>Taxable amount of conversions.</b> Subtract line 15 from line 14c . . . . .	16	10,000	--
17	<b>Amount subject to tax in 1998.</b> Check here if you elect <b>NOT</b> to spread the taxable amount on line 16 over 4 years (see page 6) . . . . . <input type="checkbox"/>			
	If you checked the box, enter the amount from line 16 on line 17. Otherwise, enter 25% (0.25) of line 16 on line 17. Include the line 17 amount in the total on Form 1040, line 15b; Form 1040A, line 10b; or Form 1040NR, line 16b . . . . .	17	2,500	--

### Part III Distributions from Roth IRAs

18	Enter the total Roth IRA distributions (withdrawals) received in 1998. Do not include amounts rolled over within 60 days of receipt. See page 6 . . . . .	18	5,000	--
19a	Enter your Roth IRA contributions for 1998, including those made during 1/1/99–4/15/99 that were for 1998. Do not include rollover contributions or amounts converted from traditional IRAs . . . . .	19a	2,000	--
b	Recharacterizations. See page 3 . . . . .	19b	0	--
c	Combine lines 19a and 19b . . . . .	19c	2,000	--
20	Subtract line 19c from line 18. If zero or less, enter -0- and do not complete the rest of Part III . . . . .	20	3,000	--
21	Subtract line 17 from line 16 . . . . .	21	7,500	--
22	Enter the smaller of line 20 or line 21 . . . . .	22	3,000	--
23	Subtract line 22 from line 20. If zero, skip lines 24 and 25, and go to line 26 . . . . .	23	0	--
24	Enter the sum of lines 15 and 17 . . . . .	24		
25	Subtract line 24 from line 23. If zero or less, enter -0- . . . . .	25		
26	<b>Taxable amount.</b> Add lines 22 and 25. Enter the result here and include it in the total on Form 1040, line 15b; Form 1040A, line 10b; or Form 1040NR, line 16b . . . . .	26	3,000	--

**Note:** If you have an amount on line 22 or 25, you will be subject to an additional 10% tax. See page 6 for details.

not owe the 10% additional tax for his withdrawal of \$5,000 from his Roth IRA. Being older than age 59 1/2 is an exception to the 10% additional tax.

We understand that the IRS is aware of this error; they will correct it on the 1999 Form, but they apparently will not correct the 1998 form.

#### Part IV of the Form—Distributions from Ed IRAs

This part of the form is new. The taxpayer reports here the amount of distributions from his or her Ed IRAs with the purpose of determining what portion of the distribution, if any, must be included in income and what portion of the distribution, if any, is subject to the 10% additional tax. The law provides that no portion of a distribution will need to be included in income as long as the person's qualified education expenses exceed the total of the IRA distributions.

Be aware that there are four worksheets included in the instructions, and these worksheets are not part of the actual Form 8606:

(1) Roth IRA Contribution Worksheet; (2) Ed IRA Contribution Worksheet; (3) Worksheet for Determining Roth IRA Basis Amounts; and (4) Ed IRA Worksheet—Distributions and Basis.

#### What tax records must any taxpayer/accountholder keep?

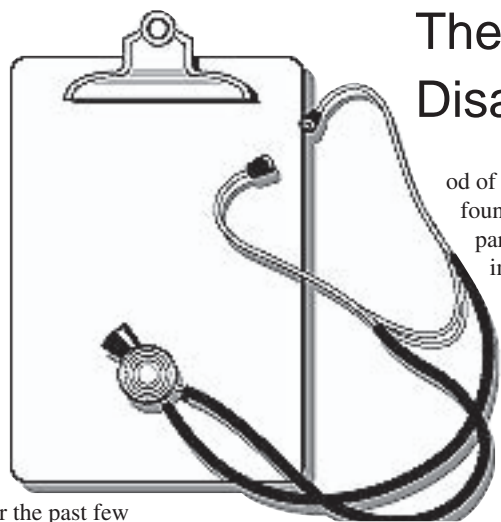
In order for any IRA accountholder to substantiate a portion of an IRA distribution as being nontaxable, he or she must keep a copy of the following forms and records for this year and all applicable prior years until all distributions have been made from that type of IRA:

1. Form 8606 for each year required to be filed;
2. Page 1 of Form 1040 filed for each year you made nondeductible contributions to a traditional IRA;
3. Form 5498 or similar statements received each year showing contributions made to a traditional IRA, Roth IRA, or Ed IRA;
4. Form 5498 or similar statements received each year showing the value of your traditional IRA(s) and Ed IRAs for each year you received a distribution; and

5. Form 1099-R and W-2P received for each year a distribution was received.

**Conclusion.** The taxpayer and not the IRA custodian/trustee will be responsible to retain the forms and statements needed as proof to determine what portion of a distribution is nontaxable. If the proper statements and forms are not retained, then the distribution will be taxable. This should create great incentive for individuals to retain the proper tax records. Even so, you know many people will fail to keep the proper records.

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## The IRS Changes the Definition of Disability – Documentation

Over the past few years in Publication 590, Individual Retirement Accounts, the IRS has gradually changed its definition of when a distribution from an IRA or other pension plan will be considered to be on account of a "disability" so that the 10% additional tax of code section 72(t) will not be owed if the person is under age 59 1/2.

There are a number of sections within the Internal Revenue code which provide a definition of disability. Code section 22(e) provides one definition and Code section 72(m)(7) provides another. The definitions are quite similar, but they are not identical. For a long peri-

od of time, the IRS applied the definition found in Code section 22(e) which can be paraphrased—a physical or mental impairment that can be expected to result in death or to last for a period of at least 12 months.

The IRS is now using the definition of disability as found in Code section 72(m)(7). It can be paraphrased—a physical or mental impairment that can be expected to result in death or to be of a long-continued and indefinite duration. The IRS has not given much guidance other than repeating the statutory requirement that the impairment must be long-continued and be of an indefinite duration. The critical difference is—meeting a 12-month requirement no longer automatically qualifies a person as disabled for the purpose of not owing the 10% additional tax. An IRA accountholder will not be able to satisfy this new definition of disability as easily as in the past. The impairment must be of an "indefinite" duration. If it is known the impairment will not exist in 24 months, then the person is not disabled as defined in Code section 72(m)(7).

Recommended administrative procedures. An IRA custodian/trustee should require that the IRA accountholder claiming to be disabled furnish a certification of disability from a doctor. The doctor should execute a form which contains the proper definition of disability as found in Code section 72(m)(7). Because the Schedule R form contains the definition found in code section 22(e), an IRA custodian/trustee should no longer accept this as a qualifying certification. You may devise your own form, or CWF or other IRA forms vendors will have a form available for your use.

We are not sure why the IRS chose to use, for the long period of time which it did, the definition of disability found in Code section 22(e) because Code section 72(t)(2)(A)(iii) stipulates the use of Code section 72(m)(7), but they did. You should modify your procedure accordingly.

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# New Options to Report IRA Recharacterizations and Reconversions

The IRS has chosen to allow IRA custodians to use alternative methods to report IRA recharacterizations and reconversions occurring in 1998 and 1999. These alternative methods are authorized by IRS Announcement 99-5 as issued by the IRS in the middle of January.

The basic concept of recharacterization is that the taxpayer is treated as having made his or her IRA contribution to the SECOND IRA rather than the FIRST IRA. For example, John Doe contributes \$2,000 to his traditional IRA on 3-15-98, but on 12-15-98, recharacterizes it a Roth IRA. Thus, his contribution on 3-15-98, is now treated as a Roth IRA contribution.

The IRS' standard procedure for reporting recharacterizations occurring in 1998 was set forth in Notice 98-49. The trustee of the IRA which received the first contribution reports the transfer to the second IRA as a distribution on the 1998 Form 1099-R with a reason code G in box 7 with the gross amount in box 1 (contribution amount plus related earnings) and a zero in box 2a. The trustee of the second IRA reports the receipt of the transferred amount as a rollover on the Form 5498.

In December, the IRS created the first alternative—it ruled that an IRA custodian could use a reason code J to report all distributions from a Roth IRA in 1998 as well as 1999, including a deemed recharacterization distribution.

The IRS' standard procedure for reporting reconversions in 1998 and 1999 was set forth in Notice 98-50. In general, an accountholder is allowed one reconversion in late 1998 or 1999. An excess reconversion generally occurs if there is more than one reconversion. When a person has one or more excess reconversions, the taxable conversion amount is the reconversion which occurred immediately preceding the first excess reconversion.

The IRS has now authorized additional reporting alternatives in the limited situation where just one financial institution is involved as the trustee of both the First IRA and the Second IRA for one or for multiple recharacterizations and reconversions. That is, the IRA custodian is not required to use the Code G and rollover approach.

The IRS has defined the same trustee requirements to be met only if the tax identification number of the trustee of each IRA is the same. If so, the trustee may report the results of these recharacterizations and reconversions on the appropriate forms using a reasonable alternative method.

The trustee is required to provide instructions to the IRA accountholder along with the appropriate forms or statements to explain how the accountholder is to use the information so that he or she properly reports the recharacterizations and reconversions on his or her tax return, including how to use the information to complete the Form 8606 and Form 5329, if applicable.



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## IRS Delays Two New Rules

The IRS has chosen to grant special relief in two pension/tax law areas.

### Delay #1—Rolling Over Hardship Distributions

Remember that the Internal Revenue Service Restructuring and Reform Act of 1998 changed the definition so that a hardship distribution occurring on or after January 1, 1999, no longer qualified as an eligible rollover distribution and thus could not be rolled over.

The IRS has recently adopted in Notice 99-5 (January 19, 1999) a special transitional rule with respect to certain hardship distributions from a qualified plan or a section 403(b) annuity. Supposedly, a significant number of qualified plan administrators argued that compliance would be too difficult as of 1-1-99, therefore, the IRS has decided, with respect to any distribution occurring in 1999, to apply the laws as they were in existence before the 1998 law change. Thus, such hardship distributions

occurring in 1999 will still be eligible to be rolled over.

The IRS tends to be very accommodating to qualified plan administrators. After granting the relief to those administrators who could not comply by 1-1-99, the IRS creates a special rule for those administrators who would comply by January 1, 1999. The IRS states that these administrators may determine the amount eligible to be rolled over or directly rolled over by excluding the hardship amount. But, the IRS goes on to say that the recipient of the distribution may still roll over the hardship amount as long as the 60-day requirement is complied with. A few years ago the IRS adopted a similar approach with respect to RMD calculations. The qualified plan administrator is authorized by the IRS to use a single life expectancy factor to determine the eligible rollover amount for a participant subject to required distribution rules even though the participant was entitled to use a joint life expectancy.

### Delay #2—Withholding Rules for IRA/Pension Distributions to Nonresident Aliens

Approximately 16 months ago, the IRS adopted final regulations covering the withholding rules for IRA/pension distributions to nonresident aliens. The June, 1996 issue of this newsletter discussed these new rules in detail. In general, the new regulations adopted the approach that Code section 1441 would govern the withholding for IRA/pension distributions to nonresident aliens rather than Code section 3405. The new rules were to be effective as of January 1, 1999. The old rules were really the reverse. Code section 3405 controlled for most distributions over Code section 1441. In general, Code section 1441 requires withholding at the flat rate of 30% unless a treaty would impose a different percentage.

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