THE Pension Digest

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ALSO IN THIS ISSUE –

IRS GRANTS A SPECIAL EXTENSION FOR RECHARACTERIZING 1998 IRA CONTRIBUTIONS

The IRS has announced that taxpayers/IRA accountholders have until October 15, 1999, to recharacterize IRA contributions made for the 1998 tax year. This is GREAT NEWS for certain IRA accountholders. For whatever reason, there were people who converted their traditional IRA, then discovered they were not eligible for the conversion, but they failed to recharacterize such contribution prior to filing their tax return on or before April 15, 1999. Without this IRS relief, there would have been many tax nightmares. Another article illustrates these harsh tax consequences.

The IRS announced this special relief in Announcement 99-57 which was published in the Internal Revenue Bulletin on June 14, 1999.

Announcement 99-57 is set forth below. You should not that this extended right to recharacterize a 1998 IRA contribution applies to all traditional IRA and Roth IRA contributions made for tax year 1998. Although the IRS does not expressly state this consequence, it appears that this same right will apply for 1999 and subsequent years.

Time for Recharacterizing 1998 IRA Contributions: Announcement 99-57

Purpose

The Internal Revenue Service has been informed that some taxpayers who have already timely filed their 1998 Federal income tax returns would like to recharacterize 1998 IRA contributions, including amounts contributed to Roth IRAs as conversions for which the taxpayers were not eligible (because their modified adjusted gross income exceeded $100,000 or because they were married individuals filing separate returns). For these taxpayers, the deadline for making the election to recharacterize is six months after the extended due date of their returns, as described below.

Background

Section 408A(d)(6) of the Internal Revenue Code and § 1.408A-5 of the regulations provide that a taxpayer may elect to recharacterize an IRA contribution made to one type of IRA as having been made to another type of IRA by transferring in a trustee-to-trustee transfer the IRA contribution, plus earnings, to the other type of IRA. For this purpose, the redesignation of an account with the same IRA trustee is treated as a trustee-to-trustee transfer. In a recharacterization, the IRA contribution is treated as having been made to the transferee IRA and not the transferor IRA. Under § 408A(d)(6) and § 1.408A-5, this recharacterization election must occur on or before the date prescribed by law, including extensions, for filing the taxpayer's Federal income tax return for the year of the contribution.

Section 1.408A-5, Q&A-6, describes how a taxpayer makes the election to recharacterize an IRA contribution. To recharacterize an amount that has been converted from a traditional IRA to a Roth IRA: (1) the taxpayer must notify the Roth IRA trustee of the taxpayer's intent to recharacterize the amount, (2) the taxpayer must provide the trustee (and the transferee trustee, if different from the transferor trustee) with specified information that is sufficient to effect the recharacterization transfer and (3) the trustee must make the transfer.

Section 301.9100-2(b) of the regulations generally provides for an automatic extension of six months from the due date of a return, excluding extensions, to make elections that otherwise must be made by the due date of the return or the due date of the return plus extensions, provided (1) the taxpayer's return was timely filed for the year the election should have been made and (2) the taxpayer takes appropriate corrective action within this six-month period.

Application of Section 301.9100-2(b) to Recharacterization Elections

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IRS Grants Extension, Continued from page 1

Pursuant to § 301.9100-2(b), in the case of a calendar-year-basis taxpayer who has timely filed his or her 1998 Federal income tax return, he or she can elect to recharacterize a 1998 IRA contribution, including a Roth IRA conversion for which the taxpayer was not eligible, provided the appropriate corrective action occurs on or before October 15, 1999. In this case, the appropriate corrective action requires taking the action described in § 1.408A-5, Q&A-6, including notifying the trustee (or trustees) and the trustee making the actual transfer (or account redesignation). The Service may invalidate a taxpayer's recharacterization election if the election is not properly reflected on the taxpayer's 1998 Federal income tax return. Thus, if the recharacterization election was not properly reflected on the return, a taxpayer taking advantage of the automatic extension described in this announcement must file an amended 1998 Federal income tax return properly reflecting the recharacterization. The amended return does not have to be filed by October 15, 1999, but must be filed by the normal deadline for amended returns.

The IRS allows the six-month extension in Announcement 99-57 because of Regulation 301.9100-2(b). The pertinent provisions of this regulation are set forth:

Section 301.9100-2 Automatic Extensions

(a) Automatic 12-month Extension

(1) In general...

(2) Elections Eligible for Automatic 12-month Extension

(b) Automatic Six-month Extension

An automatic extension of six months from the due date of a return excluding extensions is granted to make regulatory or statutory elections whose due dates are the due date of the return or the due date of the return including extensions provided the taxpayer timely filed its return for the year the election should have been made and the taxpayer takes corrective action as defined in paragraph (c) of this section within that six-month extension period. This paragraph (b) does not apply to regulatory or statutory elections that must be made by the due date of the return excluding extensions.

(c) Corrective Action

For purposes of this section, corrective action means taking the steps required to file the election in accordance with the statute or the regulation published in the Federal Register, or the revenue ruling, revenue procedure, notice, or announcement published in the Internal Revenue Bulletin (see Section 601.601(d)(2) of this chapter). For those elections required to be filed with a return, corrective action includes filing an original or an amended return for the year the regulatory or statutory election should have been made and attaching the appropriate form or statement for making the election. Taxpayers who make an election under an automatic extension (and all taxpayers whose tax liability would be affected by the election) must file their return in a manner that is consistent with the election and comply with all other requirements for making the election for the year the election should have been made and for all affected years; otherwise, the IRS may invalidate the election.

(d) Procedural Requirements

Any return, statement of election, or other form of filing that must be made to obtain an automatic extension must provide the following statement at the top of the document: FILED PURSUANT TO Section 391.9100-2. Any filing made to obtain an automatic extension must be sent to the same address that the filing to make the election would have been sent had the filing been timely made. No request for a letter ruling is required to obtain an automatic extension. Accordingly, user fees do not apply to taxpayers taking corrective action to obtain an automatic extension.

(e) Examples

Note that the six-month automatic extension is available only if the taxpayer timely filed his or her tax return for the 1998 tax year. The taxpayer must also take the appropriate corrective action by making his or her recharacterization election pursuant to Q&A-6 of the Treasury Regulation 1.408A-5. Although we do not believe the IRS makes it very clear, we would also suggest that a taxpayer file the explanations or notices for a recharacterization as required by Form 8606 and the instructions for Form 8606. This means an amended tax return Form 1040X should be prepared along with the Form 8606 and the attachment explaining the recharacterization. ◆

RECHARACTERIZATIONS AND THE TAX-FILING DEADLINE

1998 saw the creation of the new Roth IRA. This new type of IRA offers the potential for tax-free distributions and has become more and more popular as taxpayers discover the benefits this IRA offers. Along with the creation of the Roth IRA, we have also seen introduced two new types of IRA transactions, conversions and recharacterizations. A conversion occurs when an individual moves their traditional IRA funds into a Roth IRA. A recharacterization occurs when a contribution is made to one type of IRA and is subsequently moved into the other type of IRA. These transactions have been discussed at length in previous versions of this newsletter. Both of these new types of transactions were utilized quite extensively by IRA accountholders in 1998 and continuing on into 1999. Problems in how these new transactions have been handled are already becoming apparent. This article will briefly review exactly what each of these types of transactions entails and then focus on one of the most pressing problems that has arisen with recharacterizations, that being the failure to recharacterize in a timely fashion.

In order to examine the issues surrounding the problem discussed in this article, it is first necessary to understand what a conversion is, what a recharacterization is, and what

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rules govern these types of transactions. A conversion occurs when an individual takes a distribution from a traditional IRA and moves it, i.e. converts it into a Roth IRA. This is a reportable transaction. The distribution from the traditional IRA is a taxable distribution. Conversions done in 1998 were eligible for special tax treatment, that being the ability to spread amounts distributed as income over a four-year period. This special treatment often served to lessen the income tax consequences of the conversion. Distributions from a traditional IRA that are converted in 1999 and subsequent years are included as income in their entirety in the year of the distribution. In order to be eligible to make a conversion, the individual must have had modified adjusted gross income of less than $100,000, and if married, must have filed a joint tax return.

A recharacterization is a new type of transaction that in essence, allows an individual to change their mind. A contribution that was made to one type of IRA can be moved to the other type of IRA. In order to recharacterize a contribution, the original contribution plus the related earnings must be moved to the other type of IRA by the tax filing deadline of the year in which or for which the contribution was made. This deadline DOES include extensions. This transaction can be an especially useful tool when dealing with IRAs. There are a number of situations where recharacterization can be used to fix potential problems with IRA contributions or just to change the contribution in such a manner as to provide more benefit to an accountholder. We'll look at a few of these situations here. These will illustrate just how recharacterization can be utilized effectively.

Situation I – A traditional IRA accountholder converted his IRA into a Roth IRA in 1998. In February of 1999, upon completing his tax return, he discovers that his modified adjusted gross income is $110,000. As such, he is not eligible for a conversion. Recharacterization allows him to move the conversion amount, plus the related earnings, back to a traditional IRA. This recharacterization "cancels out," so to speak, the tax consequences of the original conversion transaction. Remember, in a conversion from a traditional IRA to a Roth IRA, the accountholder owes income tax on the conversion amount. The recharacterization will negate that. In this situation, recharacterization offers the means to fix an ineligible conversion.

Situation 2 – A single individual contributes $2,000 to a Roth IRA in 1998. Upon completing her tax return in March of 1999, she discovers that her modified adjusted gross income is $120,000. Remember that regular contribution eligibility for the Roth IRA is tied to income. A single individual begins to have their contribution amount phased out at $95,000 and it is gone at $110,000 of modified adjusted gross income. Since her income exceeds the $110,000 amount, she is not eligible to contribute to a Roth IRA. She has an excess Roth contribution. However, she may be able to utilize recharacterization as a means to correct this. She could move the $2,000 and the related earnings to a traditional IRA where there is no income limit. While she may or may not be entitled to a deduction for a contribution to the traditional IRA, she can at least make the contribution.

Situation 3 – A single individual who participates in a pension at work contributes $2,000 to a traditional IRA in 1998. It is later determined that he has adjusted gross income of $65,000. While he is eligible to contribute to the traditional IRA, he cannot take a deduction for the contribution. This is because he is an active participant whose adjusted gross income exceeds the $40,000 level for determining IRA deductibility for single active participants. He may not wish to leave the funds in a traditional IRA. He can recharacterize the contribution and move it to a Roth IRA, where the growth can be tax-free.

These are just a few of the situations where recharacterization can fix a problem or offer a more attractive alternative to IRA accountholders.

We have, however, seen a very real problem with recharacterization transactions occurring this year. The problem we have seen is that individual's are not getting the recharacterization done in time. Remember, the rules for recharacterization state that it must be done by the tax-filing deadline of the year in which or for which the contribution was made. If it is not done by this time, it is not a recharacterization. What is the consequence of missing this deadline? This will depend on the type of contribution that the individual wished to recharacterize.

Perhaps the worst case scenario an individual could face would be to miss the deadline for recharacterizing a contribution when the contribution in questions was a conversion. If this occurs, the tax consequences could be extremely severe. Let's look back at Situation I described previously to get an idea of how severe these consequences can be. In that situation, we had an individual convert his traditional IRA into a Roth IRA. It turned out that he was not eligible to do this because his adjusted gross income was too high. What would be the result if he did not recharacterize this by the tax-filing deadline? The first problem is that his Roth IRA has an ineligible conversion contribution in it. This is considered an excess contribution, subject to the 6% excise tax on excess contributions. The second consequence is that the conversion amount is still subject to income tax, as it was actually distributed from the traditional IRA. Distributions from a traditional IRA are taxable income. A recharacterization, in effect, "cancels out" the original transaction. However, if it is not done on time, i.e. tax-filing deadline, there is no "canceling out" the original transaction. It is also subject to tax in its entirety in 1998. This is because the special four-year rule for taxation only applies to eligible conversions. The third consequence is that it may also be subject to a 10% premature distribution penalty

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tax if the individual is not yet age 59 1/2. The exception to this penalty again only applies to eligible conversions. This one was not eligible. As such, the penalty could apply. The last potential consequence occurs should this individual have mistakenly moved the funds back to a traditional IRA after the deadline, thinking this was a recharacterization. The traditional IRA would have an excess contribution in it. Once the tax-filing deadline has passed, recharacterization is not possible. This can be a significant problem, especially with conversions. Many of the conversions we have seen are $100,000-plus transactions. Making a mistake with this would be extremely costly to the individual, as you can see.

Situations 2 and 3, while not as costly, would still present a problem if a recharacterization was not done on time. In Situation 2, where the individual was not eligible to contribute to a Roth IRA, a failure to recharacterize on time would result in an excess contribution in the Roth IRA. In Situation 3, the accountholder would not have an excess but rather a non-deductible traditional IRA contribution. In all probability, neither of these is what the accountholder desired.

We have seen numerous situations already where the accountholders were told to recharacterize but didn't come in to do it until after April 15. In other situations, the custodian/trustee was given notice that the accountholder wished to recharacterize but didn't do it until after April 15. If this occurs, recharacterization is no longer possible, nor is a "purported" recharacterization valid. Remember that the rules for recharacterization state that the contribution being recharacterized must be moved to the other type of IRA by the tax-filing deadline, including extensions, along with the related earnings. It is only by complying with this rule that the contribution can be "undone" and changed, i.e. recharacterized, and negative tax consequences avoided. As discussed on page 1, the IRS has granted a special extension for these 1998 recharacterizations which were not completed by April 15, 1999. ◆

IRA STATISTICS

Right now a relatively hot topic on the political front is what changes should be made to ensure the continued existence of social security and medicare. The policy issues being dealt with are—"Do individuals have adequate savings and assets for retirement?" and "What role should social security, IRAs and employer-sponsored retirement plans and other personal savings/assets play?"

The Joint Committee on Taxation has gathered various statistical data and other information to aid Congress, the President and the general public in making their arguments and decisions as to how the laws governing social security and medicare ought to be changed. IRAs and pensions are a possible other source of assets and income to provide for the retirement years, as are other personal savings. Presumably the concept is—to the extent that one may provide for his retirement from IRAs or pension plans or other personal savings, social security may not be needed.

For 1996, the sources of retirement income were: (1) 39% from social security; (2) 22% from wages and salary earnings; (3) 18% from employee pensions, IRAs, annuities and alimony and (4) 17% from other assets and personal savings.

The purpose of this article is to reprint a number of the statistical charts relating to private pensions and IRAs which the Committee and/or the Department of Labor has created, and their analysis of this governmental information. This information should be considered when a financial institution considers how it will grow and improve its IRA business. You should certainly review tables 13, 14, 15a, and 15b.

Before setting forth this governmental information, we will highlight some of the conclusions reached from this information.

1. There is a large amount of wealth in pension plans and IRAs. In 1997, employer-sponsored defined benefit and defined contribution plans had a total balance of 1.8 trillion dollars. In 1996, there was a balance of 1.6 trillion dollars. Even though annual contributions may not account for much growth in IRAs, rollovers from pension plans certainly do.

2. There has been a great fluctuation in IRA contributions since 1979. The level of contributions has clearly been influenced by whether or not the contribution is deductible.

1979: 2.5 million tax returns showed IRA deductions; this was 2.5% of all tax returns.

1984: 15.2 million tax returns showed IRA deductions; this was 15.3% of all tax returns.

1989: 5.8 million tax returns showed IRA deductions; this was 5.2% of all tax returns.

1994: 4.3 million tax returns showed IRA deductions; this was 3.7% of all tax returns.

The governmental information follows:

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Table 11—US Personal Savings as a Percentage of Disposable Person Income, Selected Years, 1929-1998

Year	Personal savings as a percentage of disposable personal income.	Year	Personal Savings as a percentage of disposable personal income.
1976	7.9	1988	5.4
1977	6.9	1989	5.0
1978	7.5	1990	5.1
1979	7.7	1991	5.6
1980	8.5	1992	5.7
1981	9.4	1993	4.4
1982	9.0	1994	3.5
1983	6.7	1995	3.4
1984	8.6	1996	2.9
1985	6.9	1997	2.1
1986	5.9	1998[1]	0.2
1987	5.0		

Source: Department of Commerce, Bureau of Economic Analysis.
[1] Quarterly data for third quarter, seasonally adjusted to an annual rate.

Retirement saving of individuals.—It is difficult to determine how much saving outside of qualified plans is "retirement saving." Contributions to IRAs represent one measure of such non-pension plan retirement saving. Assets within IRAs have grown substantially over the past 10 years. IRA balances, approximately $1.6 trillion in 1996, are nearly equal in size to the asset balances in both defined benefit and defined contribution plans.

The growth of these balances is impressive in its magnitude, particularly given the relatively modest contributions of recent years. Table 12, below, reports IRA contributions to IRAs increased significantly when eligibility restrictions were eliminated in 1982. At the peak in 1985, over $38 billion was contributed to IRAs. This represented almost 20 percent of personal saving for that year.

In addition to annual contributions, the current value of IRA balances is comprised of balances rolled over into IRAs from qualified plans and increases in the market value of IRA investments.

Table 12.—IRA Participation, 1980-1996

Year	Returns claiming IRA deduction (millions)	Percentage of all returns (percent)	Deductions claims ($ billions)
1970	2.5	2.6	3.2
1980	2.6	2.7	3.4
1981	3.4	3.6	4.8
1982	12.0	12.6	28.3
1983	13.6	14.1	32.1
1984	15.2	15.3	35.4
1985	16.2	15.9	38.2
1986	15.5	15.1	37.8
1987	7.3	6.8	14.1
1988	6.4	5.8	11.9
1989	5.8	5.2	10.8
1990	5.2	4.6	9.9
1991	4.7	4.1	9.0
1992	4.5	3.9	8.7
1993	4.4	3.8	8.5
1994	4.3	3.7	8.4
1995	4.3	3.6	8.3
1996	4.4	3.6	8.6

Source: Internal Revenue Service, Statistics of Income.

As with pension coverage, IRA coverage is not universal. Tables 13 and 14 summarize information on IRA participation in 1985 and 1996. Some have expressed concern about the distribution of taxpayers who contribute to IRAs. The concern is two-fold. First, unequal participation may lead to some taxpayers having accumulated substantial wealth for retirement while other taxpayers have accumulated little wealth. Second, because IRA contributions receive preferential tax treatment, the distribution of the tax expenditure may be viewed as inequitable. In 1985, 71 percent of all returns reporting IRA contributions had adjusted gross income ("AGI") below $50,000, and 29 percent had AGI of $50,000 or above. However, taxpayers with AGI of $50,000 or above represented only 8 percent of all returns eligible for IRAs. Thus, although many lower-income individuals contributed to IRAs, most did not, whereas most taxpayers with AGI of $50,000 or above did contribute when eligible. Taxpayers with AGI of $50,000 or above were more than four times as likely to contribute to an IRA than were taxpayers with AGI below $50,000—61.8 percent of eligible returns with AGI of $50,000 or above reported contributions to an IRA, while only 13.8 percent of eligible returns with AGI below $50,000 reported IRA contributions. On the other hand, the date for 1985 or 1996 represents one-year snapshots of IRA contributions. If the earning power of young individuals increases over time, an individual who did not contribute to an IRA when earning $20,000 per year may later contribute when earning $40,000 per year.

Higher income taxpayers made larger contributions as well. Taxpayers with AGI of $50,000 or more constituted approximately 29 percent of all IRA contributors in 1985, but accounted for more than 35 percent of IRA contributions. In 1996, taxpayers with AGI of $50,000 or more constituted approximately 25 percent of all IRA contributors, but accounted for approximately 34 percent of IRA contributions.

Because the value of the IRA is the effective exemption of the earnings from tax, the higher a taxpayer's marginal tax rate, the more valuable the ability to invest through an IRA. Because people in higher income classes generally have higher tax rates, the value of their IRA is larger than the value of IRAs for taxpayers in lower income classes. However, the value of the IRA depends on tax rates throughout the period the IRA is held,and not just the marginal tax rate in the year the contribution is made.

Table 13.—IRA Participant By Income Class, 1985

Adjusted gross income class	Returns reporting IRA contributions: number in millions	Percent of eligible returns[1]	Contributions ($ billions)
All classes	162	178	38.2
Under $10,000	0.6	2.3	1.1
$10,000 to $30,000	5.1	13.6	9.7
$30,000 to $50,000	5.7	32.9	13.5
$50,000 to $75,000	3.0	56.5	8.7
$75,000 to $100,000	0.9	74.1	2.7
Over $100,000	0.8	76.1	2.6

Source: Internal Revenue Service, *1985 Statistics of Income*
[1] Eligible taxpayers include self-employed persons as well as wage and salary employees. However, taxpayers whose income consists solely of interest income, for example, are ineligible to contribute to IRAs.

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Table 14.—IRA Participation by Income Class, 1996

Adjusted gross income class	Returns reporting IRA contributions: Number in millions	Percent of returns with earned income [1]	Contributions ($ billions)
All classes	4.4	4.1	8.6
Under$10,000	0.3	1.1	0.4
$10,000 to $30,000	1.6	4.3	2.8
$30,000 to $50,000	1.4	6.9	2.4
$50,000 to $75,000	0.5	3.5	1.1
$75,000 to $100,000	0.2	4.5	0.7
Over $100,000	0.4	6.6	1.1

[1] Because of the income limitations enacted by the Tax Reform Act of 1986, not all taxpayers with earned income are eligible to make deductible contributions to IRAs.

Source: Internal Revenue Service. *1996 Statistics of Income*

It is too soon to assess the effects that the Taxpayer Relief Act of 1997 may have on IRA participation and retirement asset accumulation. Tables 15a and 15b, below, present the Joint Committee on Taxation staff estimates of the eligibility of taxpayers to make deductible IRA contributions under present law for 1999. The percentage of taxpayers eligible to make deductible IRA contributions differs modestly by filing status. Among married couples filing joint returns, 58 percent are eligible for up to a $4,000 deductible contribution, an additional 15 percent are eligible for up to a $2,000 deductible contribution, and approximately 20 percent are ineligible to make a deductible contribution. Among single filers and head of household filers, only 14 percent are ineligible to make a deductible contribution.

Table 15a.—Eligibility of Taxpayers with Earned Income to Make Deductible IRA Contributions Under Present Law, Projected 1999 Returns (Returns With Earned Income for Joint Returns)

AGI	Returns	Percent eligible for full deduction for both spouses	Percent eligible for full deduction for one spouse only	Percent in phase-out range	Percent not eligible for any IRA deduction
Less than $10,000	2,987	100.0	0.0	0.0	0.0
$10,000 to $20,000	4,442	100.0	0.0	0.0	0.0
$20,000 to $30,000	4,728	100.0	0.0	0.0	0.0
$30,000 to $40,000	4,627	100.0	0.0	0.0	0.0
$40,000 to $50,000	4,985	97.3	0.0	2.7	0.0
$50,000 to $75,000	10,275	24.3	26.1	32.1	17.4
$75,000 to $100,000	6,163	13.7	40.7	0.0	45.7
$100,000 to $200,000	5,307	19.6	27.0	2.7	50.7
Over $200,000	1,821	15.7	0.0	0.0	84.3
Total	45,336	58.0	14.6	7.9	19.8
Average dollars eligible per return		$3,803	$1,997	$2,685	

Source: Joint Committee on Taxation staff estimates.

Table 15b.—Eligibility of Taxpayers with Earned Income to Make Deductible IRA Contributions Under Present Law, Projected 1999 Returns (Returns With Earned Income for Other Filers)

AGI	Returns	Percent eligible for full deduction	Percent in phase-out range	Percent not eligible for any IRA deduction
Less than $10,000	22,146	100.0	0.0	0.0
$10,000 to $20,000	15,766	100.0	0.0	0.0
$20,000 to $30,000	11,821	99.9	0.1	0.0
$30,000 to $40,000	7,517	39.9	60.1	0.0
$40,000 to $50,000	5,309	23.9	8.6	67.4
$50,000 to $75,000	5,301	17.8	0.0	82.4
$75,000 to $100,000	1,253	12.2	0.0	87.8
$100,000 to $200,000	863	16.2	0.0	83.8
Over $200,000	222	13.0	0.0	87.0
Total	70,188	78.7	7.1	14.2
Average dollars eligible per return		$1,915	$1,050	

Source: Joint Committee on Taxation staff estimates.

Other authors have noted that even the taxpayers with low income who did contribute to IRAs owned more financial assets than other low-income taxpayers and that, therefore, IRA contributors may not be representative of taxpayers in general. Table 16 presents information on the assets of households with IRAs compared to the assets of households without IRAs. For each income category, the table reports the gross financial asset holdings and non-retirement asset holdings of the median (50th percentile) household.[64] As the table details, families with IRAs have larger holdings of financial assets than do families without IRAs. However, it is also the case that families with IRAs have larger holdings of financial assets than do families without IRAs even when all IRA and pension assets are excluded. Part of the reason that IRA contributors have larger holdings of assets than noncontributors is that contributors to IRAs tend to be older than noncontributors, and older taxpayers have been accumulating assets longer.

[64] "Gross financial assets" reports only the "asset side" of the family's balance sheet. That is, these figures do not net out the value of any of the family's financial liabilities such as mortgage or consumer debt. "Gross financial assets less retirement assets" subtracts IRA and defined contribution plan asset balances from reported gross financial assets. Neither figure includes a calculation of the value of any accrued defined benefit pension plan benefits.

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Table 16.—Estimated Median Financial Asset of Families with IRAs and Families Without IRAs, 1995

AGI	Families with IRAs: Gross financial assets 1/	Families with IRAs: Gross financial assets less retirement assets 2/	Families without IRAs: Gross financial assets 1/	Families without IRAs: Gross financial assets less Retirement assets 2/
Less than $10,000	$ 56,150	$ 33,080	$ 300	$ 300
$10,000 to $20,000	49,495	18,000	1,505	1,200
$20,000 to $30,000	45,850	23,850	4,505	2,500
$30,000 to $40,000	51,875	26,800	9,000	4,450
$40,000 to $50,000	81,000	38,000	11,400	6,050
$50,000 to $75,000	118,000	68,300	33,650	17,800
$75,000 to $100,000	181,000	99,600	53,750	33,750
$100,000 and over	1,570,000	1,200,000	1,385,500	1,350,000

Source: Congressional Budget Office tabulations of the Federal Reserve Board of governors 1995 Survey of Consumer Finances.

1/ "Gross financial Assets" reports only the "asset side" of family's balance sheet. These figures do not net off the value of any of the family's financial liabilities such as mortgage or consumer debt.

2/ Gross financial assets less IRA balances and value of defined contribution pension plan assets. Does not include information regarding the accrued value of any defined benefit pension plan benefits.

PARTICIPANT OPTIONS IF LIFE INSURANCE IS A PLAN INVESTMENT

At one time it was fairly common for qualified plans to be written to authorize life insurance to be purchased on behalf of a participant. There are a number of tax reasons why it was and is beneficial to have the insurance investment purchased within a tax-preferred qualified plan rather than on a personal basis with after-tax dollars.

The purpose of this article is to illustrate the options a participant generally has when he or she qualifies to take a distribution. For discussion purposes, we will assume that David Vasquez is a participant who has an account balance of $94,000. The $94,000 is comprised of $60,000 of mutual funds, $12,000 of time deposits and an insurance policy ($100,000 of coverage) with a cash surrender value of $22,000. David has had $6,500 of PS-58 costs with respect to this policy. David Vasquez is age 47. David's employer is terminating its plan so he must decide what to do with his account. Although in certain situations it would be possible for him to roll over his mutual funds and his time deposit, for purposes of this article, it is assumed that these investments will be surrendered for cash and he will directly roll over the related cash of $72,000.

Remember that an IRA is not permitted to own life insurance and therefore it is not possible to roll over or directly roll over the life insurance policy to an IRA.

Option #1. The plan could surrender the policy to the insurance company for the cash surrender value of $22,000. This amount, too, could then be directly rolled over.

Option #2. David could have the policy distributed to him. He would want to do this if he wants to retain the $100,000 of life insurance coverage. He may now be uninsurable because of adverse health reasons. He would have to include in his income the cash surrender value of the policy (less his PS-58 costs) or $15,500. In addition, he would owe the 10% additional tax of Code section 72(t). Again, the need for the $100,000 of coverage may override the taxation results.

Option #3. David could purchase the policy from the plan. The rules set forth in prohibited transaction class exemption 92-6 (PTCE 92-6) as discussed below would need to be met. This allows him to retain the $100,000 of life insurance coverage, but he now can still roll over the amount of $87,500 ($94,000 less the $6,500 of PS-58 costs). Thus, no amount would be presently subject to taxation.

A few years ago, there was a change in the law which now makes it clear that the PS-58 value of $6,500 is not eligible to be rolled over or directly rolled over.

David Vasquez should have already paid tax on his accumulated PS-58 costs. A participant who is insured under a policy owned by a qualified plan does receive a current tax benefit and it is currently taxable. Each year the qualified plan administrator should have prepared a Form 1099-R to report as taxable these PS-58 costs. David should have included these amounts on his income tax returns.

In order to comply with the requirements of PTCE 92-6, David's purchase of the life insurance policy has to meet the following rules:

1. David must remain the insured under the contract;

2. The contract would, but for the sale, be surrendered by the plan; and

3. The amount received by the plan as consideration for the sale is at least equal to the amount necessary to put the plan in the same cash position as it would have been in had it

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✓ CHECK IT OUT

Situation/Question #1: Many of our farming customers are expressing substantial interest in establishing an MSA. If a farmer establishes an MSA and makes a contribution, on the application form or the contribution form do I check the box for an "employer" contribution or an "employee" contribution.

✓ Answer: On the MSA application and contribution forms you should be checking the "individual/employee" box rather than the "employer" box because you will need to input this contribution information into box 1 of the MSA Form 5498, "the employee's or self-employed person's regular contributions to the MSA."

The "employer" box is to be used when a business makes a contribution on behalf of an employee. It does not apply in the self-employed person's situation.

The IRS wants to distinguish between the types of contributions for purposes of determining if the statutory limits will be exceeded.

Situation/Question #2: We have a customer, Dixie Schwed, who will attain age 70 1/2 on December 2, 1999. She is retiring as of June 30, 1999. She is a participant in a defined benefit plan and a 401(k) plan. The administrator of these two qualified plans wants her to directly roll over her entire account balances to an IRA. We realize she attains age 70 1/2 in 1999 and our question is: "are there any special rules for qualified plans making it permissible for Dixie to roll over her required minimum distribution?"

✓ Answer: There is no special rule for qualified plans. In general, a qualified plan must comply with the same RMD rules which apply to IRAs. Many qualified plan administrators believe that the RMD rules do not apply in the year a person attains age 70 1/2 if they choose to roll over the funds or if they have not yet reached age 70 1/2. This is incorrect.

The law is settled that a required minimum distribution is required for the year a person attains age 70 1/2 (and not when they reach 70 1/2). The deadline for the first year's RMD is April 1of the following year. However, another rule comes into play. Code section 402(c)(4) states that a required minimum distribution is not eligible to be rolled over—this rule must be met. That is, a person does not have the right to roll over the entire amount of his or her QP balance in the year they attain age 70 1/2 because the RMD amount for that year cannot be rolled over.

If a qualified plan makes an error and rolls over the entire amount (including the RMD amount), then the following steps (or similar steps) will need to be taken to correct the error:

1. The QP plan needs to determine the RMD amount. In a rollover or transfer situation occurring in the year a person attains age 70 1/2, the regulation permits the use of a joint life expectancy as based on the beneficiary of the new plan (i.e. the IRA).

2. The QP plan will prepare one Form 1099-R with a reason code "G" for the amount which was eligible to be rolled over. Box 1 would show this amount and box 2a would be completed with a 0.00.

3. The QP plan will prepare a second Form 1099-R for the amount of the required minimum distribution. This amount will be inserted in boxes 1 and 2a, and box 7 will be completed with a reason code 7.

4. The IRA should show two types of contributions. I presume only one type of contribution is shown. The first contribution amount is the eligible rollover amount. The second contribution is the RMD amount, and it should be shown as a regular contribution. Because the person is age 70 1/2, this contribution is an excess contribution and should be withdrawn along with the related earnings.

Situation/Question #3: Is there a "scholarship" exception to the assessment of the 10% additional tax for a distribution from an Education IRA which is taxable (i.e. one which is not for qualified educational expenses).

✓ Answer #3: There is. The 10% additional tax does NOT apply when the distribution is made on account of a scholarship...received by the accountholder to the extent the distribution does NOT exceed the amount of the scholarship. ◆

Participant Options, Continued from page 7

retained the contract, surrendered it, and made any distribution owing to David of his vested interest under the plan.

In summary, if a participant has maintained life insurance as an investment, then the participant will want to consider his or her three options when it comes time to take distribution. Most plans will develop policies allowing for sale of the policy to the terminating participant if the requirements of PTCE 92-6 are met. ◆