July, 2001
Published Since 1984

# THE Pension Digest

## ALSO IN THIS ISSUE –



**Collin W. Fritz and Associates, Inc., *"The Pension Specialists"***



## New Tax Credit for Certain IRA and Elective Deferral Contributions

Congress is quite aware that many individuals are not saving as much for their retirement as most economists believe they should be. A new credit has been authorized for certain low and middle income individuals. This credit will certainly induce some of these individuals to make IRA contributions and elective deferrals. What is very special about this credit is that the individual will receive the tax benefits they otherwise would have received because of their traditional IRA contribution, Roth IRA contribution, or elective deferrals under a 401(k) or SIMPLE plan. That is, a double tax benefit will be received for those who qualify for this credit and who elect to take advantage of it. In the case of a traditional IRA, the person will be allowed a deduction for his or her contribution and will also receive the credit. In the case of the Roth IRA, a person will be entitled to the future no-tax treatment of earnings and the credit. In the case of an elective deferral contribution, a person will receive the present exclusion from income tax and the credit. Time will tell to what extent such individuals will make retirement contributions which otherwise they would not have made.

It will be important for individuals and IRA custodians to understand the rules quickly, because the eligibility rules relating to this credit have been authorized only for years 2002-2006.

In order to be eligible to claim this credit for a given tax year, a person must meet five requirements - he or she

1. must be at least 18 as of December 31 of such year;
2. must not be a dependent on some else's tax return;
3. must not be a student as defined in section 25B(c).
4. must have adjusted gross income under certain limits which are based on his or her filing status – $50,000.01 for a joint filer; $37,500.01 for a head-of-household filer; and $25,000.01 for all other filers, including married filing separately; and
5. must not have received certain distributions which disqualify him or her from claiming the credit, or certain distributions which were made to his or her spouse.

Observe that there is an income limit, but not an asset test. This means that those individuals who have a low to moderate income, but who may be considered wealthy or

Continued on page 2

## Four Tax Illustrations

The purpose of this article is to give four illustrations which show the effect of the new IRA contributions credit, the new 10% bracket, the making of a deductible contribution to a traditional IRA, and the increase in the child tax credit. These illustrations do not attempt to illustrate the changes in the tax brackets except for the new 10% bracket.

The specific intent of the IRA law change is that some of the tax savings, hopefully, will end up being contributed to an IRA or a 401(k) plan. IRA contributions in 2002 and later years may well increase for two reasons – (1) the new IRA contributions credit and (2) the new contribution limits.

Before furnishing the illustrations, it is important to understand the basic conceptual change in the tax rate tables.

The first change was to create a new income tax rate bracket of 10%. Under pre-EGTRRA law, the first dollar of taxable income was taxed at the rate of 15% regardless of filing status. Under EGTRRA the initial tax rate will be 10%, and the 15% rate will now start at the following levels:

Continued on page 2

**New Tax Credit,**
**Continued from page 1**

moderately so because of assets, will be eligible for this credit.

Also observe that there is no eligibility rule which would prevent a lower to moderate income person from borrowing funds to make his or her contribution.

The amount of a person's credit will depend upon the amount of his or her qualified retirement savings contributions for such year (as adjusted for certain distributions) and an applicable percentage which depends upon his or her adjusted gross income.

Credit = (Contributions - Certain Distributions) x Applicable Percentage (50%, 20% or 10%)

Such contribution amount is the sum of contributions to a traditional IRA, contributions to a Roth IRA, elective deferrals to a 401(k) plan, elective deferrals under a section 457 plan, and certain voluntary employee contributions. This contribution amount must be reduced by certain distributions which occur during a testing period. The testing period for a tax year is comprised of the current tax year, the two preceding tax years, and the carry-back period for such tax year (i.e. January 1 to April 15) plus extensions.

A person's total contribution amount must be reduced by any distributions from a section 401(a) plan, a 401(k) plan, a section 403(a) plan, a section 457 plan, a traditional IRA or from a Roth IRA which are not rolled over.

A person's total contribution amount must also be reduced by any distributions to the person's spouse, if a joint income tax return is filed for such tax year. This is clearly a new marriage tax provision. Apparently, Congress cannot help themselves from imposing marriage penalties.

Although it seems somewhat unfair, the literal reading of the new law does require a taxpayer to take into account any distributions which he or she received in 2000 and 2001, as well as 2002. It does not seem quite fair to be penalized for any distributions which took place prior to the enactment of the law or its effective date. The concept of the law is to have a 100% off-set for any distribution. This is true even if the distribution will not be subject to the 10% additional tax or will not be taxable for Roth IRA purposes.

The maximum contribution amount which will be taken into account is $2,000. Question – does the $2,000 limit apply before or after contributions are adjusted for distributions? Most likely the $2,000 limit applies before any adjustment for distributions.

This credit is nonrefundable and it may be used against a person's regular tax liability and alternative tax liability. In other words, if your credit is greater than your tax liability, you will not receive a refund for the difference.

Under the "ordering rules," this new credit will be applied after applying the credit for child and dependent care expenses and the child tax credit. If these credits are equal to or greater than your tax liability, you will then not be able to take the credit.

Even though the credit has been allowed, for purposes of determining gross income for section 72 taxation purposes, a person's contribution will be treated, for income tax purposes, just as if the credit had not been authorized. In other words, the receipt of the credit by the taxpayer will have no effect on how distributions from an IRA are taxed. That is, a contribution to a traditional IRA will continue to be either deductible (and taxable) or nondeductible.

The applicable percentage is determined from the following table:

| AGI Over | AGI Not Over | The Percentage |
|---|---|---|
| **If Joint Return is Filed** | | |
| $0 | $30,000 | 50% |
| $30,000 | $32,500 | 20% |
| $32,500 | $50,000 | 10% |
| $50,000 | – | 0% |
| **If a Head-of-Household Return is Filed** | | |
| $0 | $22,500 | 50% |
| $22,500 | $24,375 | 20% |
| $24,375 | $37,500 | 10% |
| $37,500 | – | 0% |
| **Filers Other than Joint Returns & Head-of-Household Returns** | | |
| $0 | $15,000 | 50% |
| $15,000 | $16,250 | 20% |
| $16,250 | $25,000 | 10% |
| $25,000 | – | 0% |

**Tax Illustrations,**
**Continued from page 1**

| | |
|---|---|
| Single | $6,000 |
| Head of Household | $10,000 |
| Married Individuals (Joint) | $12,000 |

The effect of creating this new tax bracket is a reduction in taxes to the extent of $300 for a single person (15%-10% x $6,000); $500 for a head of household (15%-10% x 10,000); and $600 for a married joint filer (15-10% x $12,000). This change applies for 2001 and all subsequent years until the sunset provision becomes effective.

The second law change was to lessen, over a number of years, the tax rates for four of the six existing brackets. For whatever reason, the 15% bracket was not changed, and the 10% bracket will not be changed. Therefore, under EGTRRA there will be six tax rate brackets, of which four will gradually be lowered over the next 6 years as –

Continued on page 3

THE Pension Digest

## Tax Illustrations, Continued from page 2

| Pre-EGTRRA | 2001-2003 | 2004-2005 | 2006 & thereafter |
|---|---|---|---|
| N/A | 10% | 10% | 10% |
| 15% | 15% | 15% | 15% |
| 28% | 27% | 26% | 25% |
| 31% | 30% | 29% | 28% |
| 36% | 35% | 34% | 33% |
| 39.6% | 38.6%. | 37.6% | 35% |

Under existing law, the 28%, 31%, 36%, and 39.6% rates apply at the following taxable income levels:

| | 28% | | 31% | | 36% | | 39.6% | |
|---|---|---|---|---|---|---|---|---|
| Single | $26,250 | to | $63,550 | to | $132,600 | to | $288,350 | to Above |
| Head of Household | $35,150 | to | $90,800 | to | $147,050 | to | $288,350 | to Above |
| Married Filing Jointly | $43,850 | to | $105,950 | to | $161,450 | to | $288,350 | to Above |

**Illustration #1.**

Holly Smith, age 23, has wage income of $23,000. She does not participate in any employer-sponsored retirement plan. She does not presently have an IRA. Her filing status is single, as she does not have any dependents. How does her income tax liability change for the years 2000, 2001, and 2002, if she makes an IRA contribution of $2,000 versus not making such a contribution?

| Tax Liability If No Contribution Is Made | 2000 | 2001 | 2002 |
|---|---|---|---|
| Wage Income | 23,000 | 23,000 | 23,000 |
| IRA Contribution | 0 | 0 | 0 |
| Adjusted Gross Income | 23,000 | 23,000 | 23,000 |
| Standard Deduction | 4,300 | 4,300 | 4,300 |
| Exemptions | 2,750 | 2,750 | 2,750 |
| Taxable Income | 15,950 | 15,950 | 15,950 |
| Initial Tax Liability | 2,396 | 2,096 | 2,096 |
| Child Tax Credit | N/A | N/A | N/A |
| IRA/ED Credit | 0 | 0 | 0 |
| Tax Liability | 2,396 | 2,096 | 2,096 |

| Tax Liability If a $2,000 Contribution Is Made | 2000 | 2001 | 2002 |
|---|---|---|---|
| Wage Income | 23,000 | 23,000 | 23,000 |
| IRA Contribution | 2,000 | 2,000 | 2,000 |
| Adjusted Gross Income | 21,000 | 21,000 | 21,000 |
| Standard Deduction | 4,300 | 4,300 | 4,300 |
| Exemptions | 2,750 | 2,750 | 2,750 |
| Taxable Income | 13,950 | 13,950 | 13,950 |
| Initial Tax Liability | 2,096 | 1,796 | 1,796 |
| Child Tax Credit | N/A | N/A | N/A |
| IRA/ED Credit | N/A | 0 | 200 |
| Tax Liability | 2,096 | 1,796 | 1,596 |
| Annual Tax Savings | 300 | 300 | 500 |

**Overall Observation**

Her tax liability for 2002 is $800 less than what it was for 2000. The liability was $2,396 for 2000 and is $1,596 for 2002. The decrease is due to – $300 for the deductible IRA contribution; $200 for the IRA credit; and $300 for the new 10% bracket.

**Observations about 2000**

1. If no IRA contribution is made for 2000, her tax liability is $2,396, meaning she will pay 10.42% of her income in federal income taxes.
2. If an IRA contribution is made for 2000, her tax liability is approximately $2,096; she will then pay 9.11% of her income in federal income taxes.
3. In 2000, Holly receives two tax benefits from making an IRA contribution. First, because she is able to claim a $2,000 deduction for her contribution, her income tax liability decreases by $300. Secondly, the $2,000 deduction is now available for investment within her traditional IRA, where earnings accumulate tax deferred.

**Observations about 2001**

1. Holly's income tax liability decreases $300 due to the new 10% bracket.
2. If no IRA contribution is made for 2001, her tax liability is $2,096, meaning she will pay 9.11% of her income in federal income taxes.
3. If an IRA contribution is made for 200l, her tax liability is $1,796; she will then pay 7.81% of her income in federal income taxes.

**Observations about 2002**

1. Holly's tax liability decreases $200 due to this new credit. The credit's applicable percentage is 10%, as her AGI is in the range of $16,250-$25,000.
2. If no IRA contribution is made for 2002, her tax liability is $1,796, meaning she will pay 7.81% or her income in federal income taxes.
3. If an IRA contribution is made for 2002, her tax liability is $1,596; she will then pay 6.94% of her income in federal income taxes.

**Illustration #2**

Same facts as illustration #1, except Holly has a daughter, so her filing will be as "head of household." How does her income tax liability change for the years 2000, 2001, and

Continued on page 4

**Tax Illustrations, Continued from page 3**

2002, if she makes an IRA contribution of $2,000 versus not making such a contribution?

| Tax Liability If No Contribution Is Made | 2000 | 2001 | 2002 |
|---|---|---|---|
| Wage Income | 23,000 | 23,000 | 23,000 |
| IRA Contribution | 0 | 0 | 0 |
| Adjusted Gross Income | 23,000 | 23,000 | 23,000 |
| Standard Deduction | 6,350 | 6,350 | 6,350 |
| Exemptions | 5,500 | 5,500 | 5,500 |
| Taxable Income | 11,150 | 11,150 | 11,150 |
| Initial Tax Liability | 1,676 | 1,176 | 1,176 |
| Child Tax Credit | $500 | $600 | $600 |
| IRA/ED Credit | 0 | 0 | 0 |
| Tax Liability | 1,176 | 576 | 576 |

| Tax Liability If a $2,000 Contribution Is Made | 2000 | 2001 | 2002 |
|---|---|---|---|
| Wage Income | 23,000 | 23,000 | 23,000 |
| IRA Contribution | 2,000 | 2,000 | 2,000 |
| Adjusted Gross Income | 21,000 | 21,000 | 21,000 |
| Standard Deduction | 6,350 | 6,350 | 6,350 |
| Exemptions | 5,500 | 5,500 | 5,500 |
| Taxable Income | 9,150 | 9,150 | 9,150 |
| Initial Tax Liability | 1,376 | 915 | 915 |
| Child Tax Credit | 500 | 600 | 600 |
| IRA/ED Credit | N/A | 0 | 200 |
| Tax Liability | 876 | 315 | 115 |
| Annual Tax Savings | 300 | 261 | 461 |

**Observations**

1. Even if she does not make an IRA contribution, her income tax liability decreases by $600, with $500 due to the new 10% bracket and $100 due to the increase in the child tax credit.

2. If she makes a $2,000 contribution each year, then her tax liability in 2000 of $1,176 will decrease by $1,061, to $115 in 2002. The $1,061 reduction in tax liability is due to the 10% tax bracket change ($461); IRA deduction ($300); IRA credit ($200) and increase in child tax credit ($100).

**Illustration #3**

Same facts as illustration #2 except Holly's AGI is now $37,000. Her filing status is still as head of household. How does her income tax liability change for the years 2000, 2001, and 2002, if she makes an IRA contribution of $2,000 versus not making such a contribution?

| Tax Liability If No Contribution Is Made | 2000 | 2001 | 2002 |
|---|---|---|---|
| Wage Income | 37,000 | 37,000 | 37,000 |
| IRA Contribution | 0 | 0 | 0 |
| Adjusted Gross Income | 37,000 | 37,000 | 37,000 |
| Standard Deduction | 6,350 | 6,350 | 6,350 |
| Exemptions | 5,500 | 5,500 | 5,500 |
| Taxable Income | 25,150 | 25,150 | 25,150 |
| Initial Tax Liability | 3,772 | 3,272 | 3,272 |
| Child Tax Credit | 500 | 600 | 600 |
| IRA/ED Credit | 0 | 0 | 0 |
| Tax Liability | 3,272 | 2,672 | 2,672 |

| Tax Liability If A $2,000 Contribution Is Made | 2000 | 2001 | 2002 |
|---|---|---|---|
| Wage Income | 37,000 | 37,000 | 37,000 |
| IRA Contribution | 2,000 | 2,000 | 2,000 |
| Adjusted Gross Income | 35,000 | 35,000 | 35,000 |
| Standard Deduction | 6,350 | 6,350 | 6,350 |
| Exemptions | 5,500 | 5,500 | 5,500 |
| Taxable Income | 23,150 | 23,150 | 23,150 |
| Initial Tax Liability | 3,472 | 2,972 | 2,972 |
| Child Tax Credit | 500 | 600 | 600 |
| IRA/ED Credit | N/A | 0 | 200 |
| Tax Liability | 2,972 | 2,372 | 2,172 |
| Annual Tax Savings | 300 | 300 | 500 |

**Observations**

1. There will be a $1,100 decrease in her tax liability. She will go from having a tax liability for 2000 of $3,272, to a tax liability of $2,172 for 2002. This is a 33% reduction. The reasons for the decrease – $300 for the IRA deduction, $200 for the IRA credit, $500 for the new 10% tax bracket; and $100 for the increase in the child tax credit.

**Illustration #4**

Mary and John are married and have two children. They file a joint return. They have an adjusted gross income of $48,000. How does their income tax situation change for the years 2000, 2001, and 2002, if they both make an IRA contribution of $2,000 versus not making such contributions?

**Continued on page 5**

The Pension Digest

**Tax Illustrations,**
**Continued from page 4**

| **Tax Liability If No Contributions Are Made** | **2000** | **2001** | **2002** |
|---|---|---|---|
| Wage Income | 48,000 | 48,000 | 48,000 |
| IRA Contribution | 0 | 0 | 0 |
| Adjusted Gross Income | 48,000 | 48,000 | 48,000 |
| Standard Deduction | 7,200 | 7,200 | 7,200 |
| Exemptions | 11,000 | 11,000 | 11,000 |
| Taxable Income | 29,800 | 29,800 | 29,800 |
| Initial Tax Liability | 4,470 | 3,870 | 3,870 |
| Child Tax Credit | 1,000 | 1,200 | 1,200 |
| IRA/ED Credit | 0 | 0 | 0 |
| Tax Liability | 3,470 | 2,670 | 2,670 |

| **Tax Liability If Two $2,000 Contributions Are Made** | **2000** | **2001** | **2002** |
|---|---|---|---|
| Wage Income | 48,000 | 48,000 | 48,000 |
| IRA Contribution | 4,000 | 4,000 | 4,000 |
| Adjusted Gross Income | 44,000 | 44,000 | 44,000 |
| Standard Deduction | 7,200 | 7,200 | 7,200 |
| Exemptions | 11,000 | 11,000 | 11,000 |
| Taxable Income | 25,800 | 25,800 | 25,800 |
| Initial Tax Liability | 3,870 | 3,270 | 3,270 |
| Child Tax Credit | 1,000 | 1,200 | 1,200 |
| IRA/ED Credit | N/A | 0 | 400 |
| Tax Liability | 2,870 | 2,070 | 1,670 |
| Annual Tax Savings | 600 | 600 | 1,000 |

**Observations**

1. There will be a $1,800 decrease in their tax liability if they make IRA contributions. They will go from having a tax liability for 2000 of $3,470, to a tax liability of $1,670 for 2002. This is a 52% reduction. The reasons for the decrease – $600 for the IRA deductions, $400 for the IRA credit, $600 for the new 10% tax bracket; and $200 for the increase in the child tax credit. ◆

# Working With Inherited IRAs

IRA custodians and trustees are having to spend more time working with inherited IRAs and the beneficiaries who inherit such IRAs. Working with inherited IRAs can be confusing for a number of reasons. First, most IRA software is 3-7 years behind the time. Second, the required distribution rules which apply to inherited IRAs can be confusing for both IRA personnel and the beneficiaries. Third, there are special reporting rules which apply to inherited IRAs.

The purpose of this article is to provide a summary of what to do with an inherited IRA – how to set up the inherited IRA(s) and how to make sure the proper governmental reports are generated by the computer systems.

This article does not address whether or not an IRA custodian or trustee will or should want to retain these deposits, or will want to encourage a beneficiary to move these funds elsewhere. In certain situations, inherited accounts may also be long-term accounts. IRA personnel must always remember, however, that an inherited IRA must be moved to another IRA custodian via a transfer, because the distribution of an inherited IRA is not eligible to be rolled over.

When an IRA accountholder dies, there is an obvious change in the relationship. In essence, an IRA custodian enters into a new relationship with the inheriting IRA beneficiaries and ends a relationship with the IRA accountholder who died. The IRA custodian needs to report certain information to the IRS with respect to the decedent and with respect to the beneficiaries. The IRA custodian has the task of preparing a final statement, final Form 5498 and a final Form 1099-R, if applicable, using the name and Social Security number of the deceased IRA accountholder. The IRA custodian will now treat the beneficiary(ies) as its customers and will be required to prepare a statement, Form 5498 and Form 1099-R, as applicable, for each beneficiary, reflecting that particular beneficiary's distribution or fair market value.

Upon learning of the death of an IRA accountholder, the first thing an institution should require is a certified copy of the death certificate. Next, the institution will research who the beneficiaries are, determine what percentage of the account each is entitled to, and set up a separate inherited IRA and file for each beneficiary. The institution will need to inform the beneficiaries of their options for payout under current required minimum distribution (RMD) rules and regulations, as well as what forms the institution requires beneficiaries to complete to accomplish their desired payout options.

A spouse beneficiary has different options than a nonspouse beneficiary. A spouse can elect to treat their decedent spouse's IRA as their own. Is it as simple as merely changing the name on the account? No, because there must be a final 5498 prepared in the decedent's name. The decedent's account must be closed, and a new IRA opened under the surviving spouse's name. A 5498 would also need to be prepared for the surviving spouse's new IRA. If the decedent was required to take an RMD, and the surviving spouse fails to take it, the account automatically becomes the account of the surviving spouse. In the situation where a spouse elects to treat the decedent's IRA as his/her own, the financial institution does not have to contend with an inherited IRA.

It is important to remember that when an inherited IRA is created for a beneficiary, the movement of funds from the decedent's IRA to the beneficiary's IRA is to be coded as a transfer. This is not a reportable event. Code 4 (death) is never to be used in this situation. This Code (4) is used when the beneficiary takes a distribution from an inherited IRA. Most

**Continued on page 6**

Inherited IRAs,
Continued from page 5

data processors do not seem to have the necessary transfer code to use in beneficiary situations; however, because this transaction must be coded correctly, institutions should make certain their software providers are aware of these rules, and request that such transfer code be incorporated into the vendor's software.

The IRA plan document governs beneficiary issues. Should a plan document spell out exactly what is required concerning inherited IRAs? Yes.

Another situation an institution may find itself in, is having a CD within an IRA which is locked into paying 6.5% interest for 18 months; after only 4 months, the accountholder dies, and the IRA becomes the inherited IRA of the decedent's children. The current CD interest rate is 4%. Is the institution justified in providing the inherited IRAs the 4% rate? If the funds are kept in a lump sum in the original CD, but the bank is able to account separately for each beneficiary, then I believe the bank must honor the 6.5%. If the bank cannot account for the IRAs in this way, and instead sets up separate CDs for each beneficiary, then I believe the bank may be able to justify the 4% rate, saying they are new IRAs. The ideal solution to this problem would be for the institution to clearly state in its literature given to any CD holder, exactly what would happen if the CD holder were to die before the CD matures.

The following examples will illustrate the necessary reporting in various inherited IRA situations.

**Example #1:**

Paul Snyder and Ela Doyle visit your financial institution on April 30, 2001. They inform you that their mother, Maura Snyder, died on November 17, 2000. They brought with them a certified copy of her death certificate and the "January IRA statement" which you had mailed to Maura's address on January 15, 2001. This statement showed the fair market value of her IRA as of December 31, 2000, to be $89,780.50. Maura had taken a nonperiodic distribution of $700 on September 10, 2000. Maura had established her IRA with your institution in March of 1979. Maura was born on February 17, 1933, and she was 67 when she died. Paul and Ela understood that their mother had designated the two of them to be her beneficiaries and that each was to receive 50% of her account. They were correct.

Paul and Ela have come to your institution well prepared. Both know that the law requires that distributions of a certain minimum amount be paid to them because this is an "inherited IRA." Paul informs you that he elects to use the five-year rule to withdraw his share. He wishes to withdraw $10,000 on July 5, 2001, and he then would like to receive approximately four equal payments on each July 5. Ela has informed you that she will be using the life-distribution rule to withdraw her share. Ela was born on April 4, 1959.

The value as of the date of death was $89,067.95. The value of the IRA today, April 30, 2001, is $90,880.28.

**What Reporting Must Be Done with Respect to Maura?**

1. The 2000 Form 1099-R and Subsequent Years' 1099-Rs. You need to prepare the 2000 Form 1099-R using her name, address and Social Security number, as she was paid $700 from her IRA prior to her death. You will never again prepare a Form 1099-R using her name, address or Social Security number because subsequent distributions will be made to her children. A Form 1099-R is always issued to the person who received the distribution.

2. The December 31, 2000, Fair Market Value Statement and Subsequent Years' Statements. The 2000 statement was prepared using the name, Social Security number and address of Maura and the fair market value as of December 31, 2000, because you had no knowledge of her death on January 15, 2001, when you prepared the statements. The IRS does not require an IRA custodian to issue a corrected statement unless one would be requested by the personal representative. The IRA custodian could elect to do this voluntarily. This is the last statement which your institution will be required to prepare. This statement may be needed so that the decedent's final income tax return may be prepared or possibly, for estate tax purposes. The fair market value information will be needed if the decedent received a distribution prior to death and if the decedent had ever made a nondeductible contribution. Maura had never made a nondeductible contribution, so her personal representative will not need to know the actual value as of the date of death.

3. The 2000 Form 5498 and Subsequent Years' 5498s. Because the due date for the 2000 form is May 31, 2001, you are required to prepare the 2000 form using Maura's name, address and Social Security number, and you will need to complete Box 4 with either the fair market value as of the date of death, or by inserting a zero. Most IRA custodians will complete Box 4 with zero and then furnish the notice that the personal representative may request the actual date-of-death value if it is needed. A minority of IRA custodians choose to furnish the actual date-of-death value.

   As with the 2000 statement, the 2000 Form 5498 for Maura is to be the final Form 5498 which your institution shall prepare using her name, address, etc.

**What Reporting Must Be Done with Respect to Paul?**

As various reporting forms are discussed below, the critical fact to remember is that Paul now "owns" an inherited IRA. Special distribution rules apply to inherited IRAs.

1. The 2000 Form 1099-R and Subsequent Years' Form 1099-Rs. Your institution will not prepare a 2000 Form 1099-R for Paul, because he did not withdraw any funds from the

Continued on page 7

The Pension Digest

**Inherited IRAs,
Continued from page 6**

IRA in 2000. Your institution will prepare a 2001 Form 1099-R for Paul using his name, address and Social Security number, because he was paid $10,000 from his "inherited IRA." Your institution will also prepare a 2002 Form 1099-R, 2003 Form 1099-R, 2004 Form 1099-R and a 2005 Form 1099-R for the subsequent distributions. The reason code for a distribution from an inherited account is always "4" (death). Since Paul had indicated he wanted four equal payments, and since you have given him a fixed interest rate of 6.5%, the amount he will be paid each installment in 2000-2003 will be approximately $8,862.50.

Note that the creation of the inherited IRA on the data processing system should not have the result that a 2001 Form 1099-R is prepared in either Maura's name or Paul's name. That is, when the funds are moved from Maura's account to Paul's inherited account in 2001, this transaction must be treated as a nonreportable transfer and not as a reportable distribution.

2. The 2000 Fair Market Value Statement and Subsequent Years' Statements. Your institution did not prepare a 2000 statement for Paul using the inherited title because you had not known about Maura's death at the time the statements were prepared. Your institution is not required by any IRS rule to issue a statement to Paul reflecting the December 31, 2000 value of his inherited IRA unless he would request one. Because this is an inherited IRA, the statement would be titled, "Paul Snyder as the IRA Beneficiary of Maura Snyder." Paul's address and Social Security number are to be used. The fair market value of Paul's inherited IRA as of December 31, 2001, is $44,890.25 (50%). Your institution will be required to prepare a 2001 statement, a 2002 statement, a 2003 statement, and a 2004 statement reflecting the respective fair market values as of December 31. You will not need to prepare one for 2005, because the balance in the account as of December 31, 2005, will be zero.

3. The 2000 Form 5498 and Subsequent Years' 5498s. You will be required to prepare a 2000 Form 5498 for Paul using the inherited title, his address, his Social Security number, and the fair market value of $44,890.25, because you have knowledge that Maura died before the deadline for furnishing this form. The title of this account for reporting purposes should be, "Paul Snyder as the IRA Beneficiary of Maura Snyder," The deadline is May 31, 2001. You must report "his share" of Maura's IRA as of December 31, 2000. This would be true even if Paul had not yet decided the method he would use to take his required minimum distributions. As long as a balance remains within this IRA as of any December 31, you will be required to prepare a Form 5498 for it. Because Paul has instructed you that he will take this final distribution on July 5, 2005, you will prepare the 2000-2004 Form 5498s, but you will not need to prepare the 2005 Form 5498, because there will be no fair market value as of December 31, 2005.

### What Reporting Must be Done With Respect to Ela?

Ela now "owns" her inherited IRA. The reporting which you must do for her will be very similar to that which is needed for Paul. The primary difference will arise because Ela wishes to use the life-distribution rule to satisfy the required minimum distribution rules, whereas Paul chose the five-year rule.

1. The 2000 Form 1099-R and Subsequent Years' Form 1099-Rs. The election of the life-distribution rule requires that Ela commence a distribution schedule over her life expectancy commencing not later than December 31 of the year after the year during which Maura died. December 31, 2001, is her deadline. She had the option of commencing distribution in 2000, but she either was not aware of her choice to commence distribution in 2000, or she chose not to commence distribution in 2000. You will not prepare a 2000 Form 1099-R for her, because there was no distribution to her in 2000. You will need to prepare a 2001 Form 1099-R and one for every subsequent year during which she is paid a distribution. As with every distribution from an inherited IRA, the reason code will be Code "4" (death). This minimum amount which she is required to be paid in 2001 is $1,032.99, which is the balance of $44,890.25 (December 31, 2000) divided by the life-expectancy factor of 43.5. The factor is determined by determining Ela's age in 2001 and then looking to the applicable life-expectancy table (single) to determine what factor relates to that age. Ela is age 39.

2. The 2000 Fair Market Value Statement and Subsequent Years' Statements. As with Paul, you will not need to prepare a 2000 statement for "Ela as the IRA beneficiary of Maura" unless she would request it, since you had no knowledge of Maura's death until after January 31, 2001. Her value of 50% was $44,890.25. You will be required to prepare a statement for each year in which there is a fair market value as of December 31. This could be for very many years, as Ela has elected to use the life-distribution rule.

3. The 2000 Form 5498 and Subsequent Years' Form 5498s. As with Paul, you will need to prepare a 2000 Form 5498 showing the value of $44,890.25, because you had knowledge of Maura's death prior to the reporting deadline of May 31, 2001. You will be required to prepare a Form 5498 for each year in which there is a fair market value as of December 31.

An IRA custodian has special IRS reporting duties with respect to inherited IRAs. An administrative system needs to be established to make sure the Form 1099-R, January statement, and Form 5498 are being prepared as required.

**Continued on page 8**

**Inherited IRAs,**
**Continued from page 7**

The above example illustrates the reporting duties when the IRA owner had designated a nonspouse beneficiary or beneficiaries.

**Example #2**

In this hypothetical situation, Philip Snyder, Maura's husband, is the sole beneficiary of Maura Snyder, rather than Ela and Paul. He walks into your institution on February 28, 2001, and informs you that Maura died on November 17, 2000. He furnishes you with her death certificate. He informs you that he is electing to treat her IRA as his own. He also informs you that he wishes to withdraw $6,000 today. Philip's date of birth is May 15, 1929. What governmental and customer reporting must your institution, as the IRA custodian, prepare with respect to Maura and Philip?

**What reporting must be done with respect to Maura?**

The same reporting as discussed in Example #1 must be completed and for the same reasons.

**What reporting must be done with respect to Philip?**

Note that Philip did not elect to treat Maura's IRA as his own in 2000. Thus, for 2000 reporting and administrative purposes, this IRA is an inherited IRA. It will have the title, "Philip Snyder as the IRA Beneficiary of Maura Snyder." The movement of the funds into this inherited IRA should not be reported as a rollover contribution. The funds were transferred in.

1. The 2000 Form 1099-R and Subsequent Years' Form 1099-Rs. A 2000 Form 1099-R should not be issued to Philip because there was no distribution to him. A 2001 Form 1099-R must be issued to Philip Snyder since he has asked to be paid $6,000 in 2001. A Form 1099-R will not be prepared because he has instructed you that he wishes to treat Maura's IRA as his own. The movement of the funds from Maura's account, or the inherited account (Philip Snyder as the IRA Beneficiary of Maura Snyder) to Philip's own IRA is a nonreportable transfer.

The reason code with respect to the payment of $6,000 will either be "4" (death) or "7" (normal). Which code is the proper code depends upon whether he elected to treat the entire account as his own and then he took a distribution of $6,000, or whether he first took the distribution of $6,000 from the inherited IRA and then elected to treat the remainder as his own. Most IRA spousal beneficiaries and IRA custodians will find it simplest, from an administrative viewpoint, to elect to treat the entire account as the beneficiary's own, and then have the beneficiary take the distribution from his own IRA.

2. The 2000 January Statement and Subsequent Years' Statement. Again, the IRA custodian is not required to prepare and furnish Philip with a 2000 statement for the inherited IRA unless he would request one, since the deadline for furnishing the statement has passed. Since he has elected to treat her IRA as his own in 2001, each and every statement commencing with the 2001 statement will be generated in his name and Social Security number, and not as an inherited IRA.

3. The 2000 Form 5498 and Subsequent Years' Form 5498s. You, as the IRA custodian, will be required to prepare a 2000 Form 5498 for the inherited IRA as "Philip Snyder as the IRA Beneficiary of Maura Snyder." The fair market value to be reported for 2000 is $89,780.50. The 2000 Form 5498 and subsequent years' 5498s will need to be prepared using his name. That is, the IRA is no longer an inherited IRA once he has elected to treat it as his own.

**Conclusion**

An inherited IRA must be properly accounted for on an institution's computer system. Because the transfer of funds to an inherited IRA is not a reportable event, steps must be taken to make certain the transaction is coded as a transfer and not as a transaction which would trigger a taxable event for the beneficiary. Since most software does not contain provisions for this situation, software vendors need to be informed and take steps to update their software. Final reporting must be done with respect to the decedent, and correct reporting must be done for the beneficiary for each year in which funds remain in the account. ◆