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IRS Issues Guidance

Rules and Deadlines for Using Revised IRA Plan Documents and Furnishing Amendments

The IRS has recently furnished various deadlines for using revised IRS model IRA forms for traditional IRAs, SEP IRAs, SIMPLE IRAs and Roth IRAs. These deadlines are found in Revenue Procedure 2002-10. This Revenue Procedure is effective as of January 28, 2002.

There are different rules depending upon whether the existing IRA (traditional, SIMPLE or Roth) was established using an IRS Model form or a prototype.

Model IRA Forms.
The model IRA forms are:
5305, Individual Retirement Trust Account
5305-A, Individual Retirement Custodial Account
5305-R, Roth Individual Retirement Trust Account
5305-RA, Roth Individual Retirement Custodial Account
5305-RB, Roth Individual Retirement Annuities Endorsement
5305-5, SIMPLE Individual Retirement Trust Account
5305-SA, SIMPLE Individual Retirement Custodial Account

The rules and deadlines for Model IRA forms are:

#1 Existing IRA plan agreement forms (model forms) shall not be used after June 1, 2002. They will need to be discarded and new forms will need to be purchased.

#2. An existing IRA accountholder who wants to take advantage of the 2002 EGTRRA changes to IRAs in 2002 must ADOPT an updated IRA form or prototype by December 31, 2002.

Apparently those IRA accountholders who do not want to take advantage of the 2002 EGTRRA changes do not need to adopt the updated IRA form.

CWF Observation. We see an IRA custodian/trustee being able to select from the following two options for amending its existing IRAs. The first option is to mail all of your existing IRA accountholders the forms they will need to amend such IRAs. See the discussion which follows as to the forms which CWF will have available. The second option is to have new forms signed only by those who come into your institution. One can see that there will come a point in time when the second option causes problems since you should not accept a contribution or do certain rollovers if the plan agreements have not been updated.

IRS Issues Favorable Opinion Letters

With Respect to CWF's GUST QP Prototypes and discussing the EGTRRA Amendment Process

On January 10, 2002, the IRS issued favorable letters with respect to the eight prototypes which CWF sponsors. In general, these prototypes have been rewritten to incorporate the many law changes which were enacted from 1993-2000 (GUST changes). Remember that a qualified plan is "qualified" only if the plan document is written to conform to then existing law and is operated in accordance with such document.

The business customers of those financial institutions which had CWF file their GUST prototypes with the IRS by December 31, 2000, will have until February 28, 2003, to adopt (i.e. sign) these prototypes, allowing them to retain their tax "qualified" status on a retroactive basis.

EGTRRA was enacted on June 7, 2001. In general, the law changes go into effect as of January 1, 2002, for plan years commencing on or after January 1, 2002.

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#3. The IRA disclosure statement must be revised to reflect the new IRA rules, and it must be distributed to each individual using the IRA form as revised for EGTRRA.

This apparently means a revised IRA disclosure statement does not need to be furnished to those IRA accountholders who do not wish to take advantage of 2002 EGTRRA changes.

The IRS does not really say when the revised disclosure statement must be furnished. Internal Revenue Code regulation 1.408-6 provides that an IRA custodian must furnish an amended IRA disclosure statement no later than 30 days after the later of: the date on which the amendment is adopted or becomes effective. From a practical standpoint, it appears an IRA custodian/trustee will be in compliance as long as they furnish the revised IRA disclosure at the same time they furnish the revised IRA plan agreement.

The IRS has said that IRA forms must be revised for EGTRRA. And the IRA forms will also be revised to include the new required distribution rules.

We, at CWF will also be adding some additional contractual provisions. For example, we will be adding a provision to allow a beneficiary to designate a beneficiary. We will also be making additional changes.

What revised IRA plan agreement forms will CWF have and when will they be available? We will have our standard IRA forms available within 15 business days of when the IRS issues the final IRA model forms. Earlier, the IRS had posted on its web site that they intended to issue the forms on January 22, 2002. In Revenue Procedure 2002-10 the IRS states that they will be ready in early 2002. Our standard forms are:

40C, 41T and 42SD	traditional IRAs
40RC, 41RT and 42RSD	Roth IRAs
940, 941 and 942	SIMPLE-IRAs

What amendment forms will CWF have and when will they be available? We will have our standard Comprehensive amendments available along with an "adopting" application form. We would suggest that you mail your existing IRA accountholders the following:

1. A cover letter explaining the fact that they need to sign or adopt the IRA changes, and they will need to return one copy to the institution; they are to keep one copy.

2. A copy of the IRA application or adoption form. This will need to be signed by bank personnel before it is mailed.

3. A copy of CWF's applicable comprehensive IRA amendment.

We will have these amendments available within 25 business days of when the IRS issues the final IRA model forms. We expect that many IRA custodians and trustees will furnish the amendment forms at the same time the 5498 forms are mailed.

Employers Adopting SEP or SIMPLE MODEL IRA Forms

The rules and deadlines for Model SEP and SIMPLE forms are:

#1. The IRS expects to issue revised model forms in early 2002.

#2 Existing SEP and SIMPLE IRA forms may not be used after June 1, 2002, to establish new plans. Such forms will need to be discarded and new forms will need to be purchased.

#3. If an employer wishes to take advantage of EGTRRA, but it has an old 5305-SEP form, it will need to sign a revised 5305-SEP or a revised SEP prototype by the end of the first plan year commencing after December 31, 2001. For calendar year plans, the deadline will be December 31, 2002.

#4. If an employer wishes to take advantage of EGTRRA, and the employer has an old 5304-SIMPLE or old Form 5305-SIMPLE, then this employer will need to sign a revised 5304-SIMPLE or 5305-SIMPLE or a revised SIMPLE prototype by December 31, 2002. In addition, the participating employees will need to be notified by October 1, 2002 of the increased contribution limits. One would expect this will be covered in the revised SIMPLE IRA disclosure statement and also in the summary description.

Adopters of an IRA Prototype, SEP Prototype or SIMPLE Prototype

The rules and deadlines for these prototypes are:

#1. The IRS will begin accepting revised prototype filings on April 1, 2002. CWF will be making a SEP filing at that time. We will be in contact with all past adopters of CWF's SEP prototype.

#2. A prototype sponsor (IRA, SEP, and SIMPLE) has only until December 31, 2002, to submit a revised prototype in order to remain a prototype sponsor of such documents.

#3. The IRS has issued the following special rules for annuities:

.03 Annuities. In the case of a prototype sponsor that is an issuer of individual retirement annuities described in §408(b) and that must apply to one or more state

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insurance departments for approval of amended IRA documents, the Service will grant expedited review of Service-approved EGTRRA prototype IRA documents amended for changes required by a state insurance department, provided: (1) the Service-approved EGTRRA document is submitted to the state insurance department within 90 days of the date the Service issues a favorable EGTRRA opinion letter on the document and; (2) the prototype sponsor resubmits the document, as amended to comply with changes required by the state insurance department, to the Service within 90 days after it is approved by such state insurance department.

#4. If the revised SEP prototype is filed by the sponsor with the IRS by December 31, 2002, then an employer currently using an approved SEP prototype must adopt the prototype sponsor's amended document within 180 days after the date the IRS issues a favorable opinion on the amended document.

#5. If the revised SIMPLE prototype is filed by the sponsor with the IRS by December 31, 2002, then an employer currently using an approved SIMPLE prototype must adopt the prototype sponsor's amended document within 180 days after the date the IRS issues a favorable opinion on the amended document.

#6. The IRS has also authorized transitional relief for certain individuals who establish an IRA, SEP and/or SIMPLE by using a document which does not have an EGTRRA opinion letter. They will be deemed to have used an EGTRRA approved document if the following 4 conditions are met:

1. The document which is used has been provided by a prototype sponsor;

2. No later than December 31, 2002, the prototype sponsor files the prototype for an opinion letter;

3. The new document is adopted within 180 days after the IRS issues a favorable opinion letter.

4. There is compliance in operation with applicable statutory limits for the period beginning on the date the IRA, SEP or SIMPLE was established, as the case may be, through the date the IRS approved document is adopted.

Summary. The IRS has furnished various deadlines for using the revised and updated IRA forms, SEP forms, SIMPLE IRA forms, Roth IRA forms etc. The deadlines are reasonable. It is hoped the IRS will issue the revised Model IRA forms in the very near future along with revised LRM's (Listing of Required Modifications) for the prototype plans. ◆

Confusion with the 2002 SEP Contribution Limits?

Is the per person SEP contribution limit for 2002 $40,000 or $30,000?

Is the employer's deduction limit for 2002 25% or 15%? The answers to these questions are not simple. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) made many changes in the laws governing employer-sponsored retirement plans. In general, many of the contribution and deduction limits were increased for many types of plans. With respect to SEPs, the employer's deduction limit is set forth in Code section 404(h). It was changed so that the amount deductible in a tax year for a SEP shall not exceed 25% of the compensation paid to the employees during the calendar year ending with or within the taxable year. The old limit was 15% of compensation.

However, there is another special SEP limit in Code section 402(h) and this limit was not changed by EGTRRA. Code section 402(h) sets forth the rule that any amount contributed in excess of 15% of compensation is treated as made available to the person (and then contributed as an IRA contribution). It appears that the lawmakers simply forgot to make the corresponding change to section 402(h).

One would think that because the intent was to change the limit to 25% it is only a matter of time before Code section 402(h) will be changed also. There may be a subsequent tax bill correcting for this error. However, economic and political times have changed, and the technical correction may not now come as quickly, if at all.

What is the importance of this law gap? In very simplistic terms, it is the difference between having a maximum per-person SEP contribution of $40,000 (the "415" limit) (and the lesser of $40,000 or 25% of $200,000) versus $30,000 (15% of $200,000). But there is more to it.

In the past, when a contribution exceeded the 15% limit for a person, the IRS required the employer to include this excess in the person's W-2 income. The excess amount was then subject to the withholding rules and social security and medicare taxes. Within the IRA, this excess was either treated entirely as an excess contribution, or, to the extent of the excess contribution minus $2,000. Because it was an excess contribution (and also because it was being taxed as wages), the amount could be withdrawn with minimal adverse tax consequences. If income had to be allocated to the excess amount prior to correction, that income would be included in income and taxed, and it would be subject to the 10% additional tax of Code section 729t), if applicable.

The law, in Code section 404(h), clearly allows the employer to make and deduct a SEP contribution of up to 25% of compensation. Any IRS argument that the 10%

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excess (25% -15%) is not a SEP contribution and must be treated as wages is not a strong argument. It will be interesting to see the position the IRS sets forth in the model SEP-IRA form, the Form 5305-SEP.

The best of all worlds for employers would be that the IRS would adopt an administrative position that Code section 402(h) was intended to be revised, and therefore the IRS would not enforce it. It is unlikely the IRS will adopt this position. Code section 402(h) exists and says that any amount in excess of 15% will be treated as a normal IRA contribution. Most, if not all, of this contribution may be an excess IRA contribution. But it is a different type of excess which the law has not contemplated.

The IRS will need to adopt a position as to how the excess 10% should be taxed when it is distributed from the IRA.

The general rule for withdrawing an excess contribution is that if the withdrawal occurs before April 15 of the following year (plus extensions), then the excess is not required to be included in income, but the allocable income is required to be included in income and is subject to the 10% additional tax, if applicable.

Applying the general rule would mean the 10% excess would NOT be included in income (either as wages or as a distribution from an IRA). The IRS will NOT adopt this position because to do so would mean the 10% amount would not be taxed at all.

Another rule provides that if the distribution is included in income, the 10% additional tax will generally be owing if the recipient is not age 59 1/2 or older. The IRS most likely will conclude that the 10% additional tax will be owed by a person who withdraws the 10% excess and who is younger than age 59 1/2.

The fact that SOME employees will have to pay the 10% additional tax since they are younger than 59 1/2 does not mean that an employer should not make the 25% contribution to the SEP. The additional 10% amount is not subject to social security and/or medicare taxes which, for most employees, is 15.3% (7.65% by the employer and 7.65% by the employee). 15.3% as applied to all participants will be greater than the 10% tax applied to just some participants.

In summary, the law is unclear as to whether the SEP contribution limit is 15% of compensation or 25% of compensation. In normal political times, there would be a technical correction bill to resolve this problem. These are not normal political times. The two political parties are not in a cooperating mood, as it is an election year. There very well may not be a technical corrections bill in the immediate future. The law will have to somehow be administered as written. ◆

Processing and Reporting the Correction of 401(k) Corrective Distributions

It is January of 2002, so it is that time of year when the 2001 Form 1099-R is being prepared to report the "normal" distributions which were paid to 401(k) participants during 2001. There may also been "corrective" distributions throughout 2001 for 2000, but many probably occurred before March 15, 2001. And there will certainly be corrective distributions paid out in 2002 with respect to the 2001 plan year.

A corrective distribution is one which is made to correct a contribution which did not qualify to remain in the plan because it does not qualify under one or more of the antidiscrimination tests. The purpose of this article is to cover the procedures for handling corrective distributions for excess deferrals, excess contributions and excess aggregate contributions. Although such procedures certainly include preparing and furnishing the Form 1099-R, they involve more than that.

The plan administrator is required AT THE TIME OF DISTRIBUTION to inform the recipient of the YEAR or YEARS in which he or she must include this distribution in income for income tax purposes, and that it may be necessary to file an amended return for a prior tax year.

The Form 1099-R is to be prepared for the year the distribution of the excess contribution plus earnings takes place, regardless of the year when the distribution is taxable to the recipient. Normally, the recipient will be the participant. In some cases, the administrator will be required to prepare two Form 1099-R's so that the excess contribution will be shown as taxable in one year, and the earnings as taxable in a second year.

Before discussing the various types of corrections which may need to be corrected and reported, there will be a discussion of the distribution codes which will be used to report such corrective distributions. You may also wish to read the separate article, Completing the 2001 Form 1099-R for Distributions from a Qualified Plan.

The plan administrator will use either the 8, P or D and also a secondary code, as applicable.

We summarize the rules for the various reporting codes as follows:

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Primary Code	When to be Used	May be Used With one other code
8- Excess Deferrals (and/or earnings) taxable in 2001.	To be used if Code P or D does not apply To be used when the correcting distribution is to be taxable in 2001	1, 2, or 4
P- Excess Deferrals (and/or earnings) taxable in 2000	To be used when the correcting distribution is to be taxable in 2000 To be used if Code 8 or D do not apply	1, 2, or 4
D- Excess Deferrals (and/or earnings) taxable in 1999	To be used when the correcting distribution is to be taxable in 1999 To be used if Code 8 or P do not apply	1, 2, or 4

EXCESS ELECTIVE DEFERRALS - HOW CORRECTED?

A participant who contributes, via his or her elective deferrals, more than the annual amount authorized by Code section 402(g) has made an excess elective deferral. The annual limit for 1999 was $10,000, for 2000 was $10,000; the annual limit for 2001 was $10,500.

The elective deferral limit is a per-person limit. If a person participates in more than one plan which allows for elective deferrals, he or she must aggregate all of his or her elective deferrals and comply with the $10,500 limit for 2001.

Under all 401(k) plans, a participant has the right to instruct the administrator whether or not he or she has made an excess elective deferral, as long as notice is given before March 15. For example, if a person works for two hospitals during 2001, and makes elective deferrals under both of the hospitals' 401(k) plans to the extent of $14,000, then this person will want to instruct one of the hospitals that he or she will need to withdraw $3,500.

If distributed BY April 15 of the year following the year of the elective deferral contribution (e.g. 4-15-2002, if for the 2001 plan year ending 12-31-01), the excess portion is taxable to the participant in the year of the deferral, but the earnings are taxable in the year of the distribution.

For example, in the above example let's assume that the $3,500 had $300 of related earnings so that a total of $3,800 will be distributed on 4-4-2002. The individual will include $3,500 on his or her tax return for 2001, and the $300 of earnings will be included on her tax return for 2002. There would be a 2001 Form 1099-R furnished on or before January 31, 2002, and a 2002 Form 1099-R furnished on or before January 31, 2003,

If distributed AFTER April 15 of the year following the year of the elective deferral contribution, the excess portion is taxable to the participant in the year of the deferral AND THE YEAR OF DISTRIBUTION. In order to encourage a person to not violate this limit, the law imposes double taxation as the penalty if the person does. Because the amount of elective deferrals IS reported on the Form W-2 by each employer, a person will most likely be caught if they try to exceed the annual limit.

The payment of excess elective deferrals is not subject to federal income tax withholding or to social security and medicare taxes. The individual will include the total amounted distributed in his or her income for the year indicated on the Form 1099-R. It makes sense that the payment or distribution of excess elective deferrals is NOT subject to social security tax and medicare tax, because they have already been subject to such taxes at the time the payroll was paid.

Note that the W-2 form of the participant is not required to be corrected for exceeding the $10,500 limit. The IRS provides the following example on page 9 of the 2001 instructions for the 2001 Form W-2:

"Example of reporting elective deferrals to a section 401(k) plan. For 2001, Employee A elected to defer $11,300 to a section 401(k) plan and made a voluntary after-tax contribution of $600. In addition, the employer on A's behalf, made a qualified nonelective contribution of $1,000 to the plan and a nonelective profit-sharing employer contribution of $2,000.

The total elective deferral of $11,300 is reported in box 12 with Code D (D 11,300). Even though the 2001 limit for elective deferrals is $10,500, the employer must report the total of $11,300 in box 12. The excess is not reported in box 1 (gross wages).

The $600 voluntary after-tax contribution may be reported in box 14 (this is optional) but not in box 12. The $1,000 nonelective contribution and the $2,000 nonelective profit sharing contribution are not required to be reported on Form W-2, but may be reported in Box 14.

Mark the "Retirement plan" checkbox in box 13."

LOSSES (AND NOT GAINS).

2001 was not a good year for most securities and related investments because there were realized and unrealized losses.

In the case were the amount to be returned to the person who made the excess elective deferral is less than what was contributed because losses were allocated to the original excess contribution, the amount of the "net" corrective distribution is to be reported in box 1 and box 2a of Form 1099-R for the year of the distribution, with the appropriate distribution code in box 7.

The taxpayer must include the total amount of the excess deferral amount (unadjusted for any loss) in income for the year of the deferral.

The taxpayer may report a loss on the tax return for the year the corrective distribution is made.

Boxes 1 and 2a will be completed with the fair market value of the cash and/or property distributed, and there is to be no entry in box 5 as long as employer securities were not distributed.

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Boxes 1 and 2a will be completed with the fair market value of the employer securities, and there is to be no entry in boxes 5 or 6 as long as ONLY employer securities were distributed.

If the distribution was comprised of both employer securities and cash or property not being employer securities, then show the actual cash and/or FMV of the property being distributed in box 1, the gross amount less any net unrealized appreciation (NUA) of the employer securities in box 2a, no entry in box 5, and any NUA in box 6.

EXCESS CONTRIBUTIONS

A HCE (highly compensate employee) participant may be required to withdraw a portion of his or her elective deferrals because the plan does not satisfy the ADP test.

If the correcting distribution to the participant occurs within 2 1/2 months after the close of the plan year (normally this will be March 15), then the excess and the earnings are taxable to the participant in the year of deferral. Excess contributions distributed within the 2 1/2 month period are not subject to federal withholding rules and are not subject to the social security and medicare taxes because such taxes were imposed at the time the original payroll was paid, even though such funds were selectively deferred.

If the correcting distribution to the participant occurs AFTER 2 1/2 months after the close of the plan year (normally this will be after March 15), then the excess and the earnings are taxable to the participant in the year distributed. The federal income tax withholding rules apply to a correcting distribution after 2 1/2 months after the end of the plan year.

There is a de minimis rule even if during the 2 1/2 month period. If the total of the excess contributions and excess aggregate contributions are less than $100 (excluding earnings), then the distribution is taxable in the year of the distribution.

For excess contributions which are corrected by recharacterization rather than by distribution, then the excess (not the earnings) is taxable in the year a corrective distribution would have occurred.

EXCESS AGGREGATE CONTRIBUTIONS.

An excess aggregate contribution arises when the plan does not meet the ACP test.

If the correcting distribution of excess aggregate contributions to the participant occurs within 2 1/2 months after the close of the plan year (normally this will be March 15), then the excess and the earnings are taxable to the participant in the year deferred. Such contributions are not subject to federal withholding rules and not subject to social security and medicare taxes.

If the correcting distribution of excess aggregate contributions to the participant occurs AFTER 2 1/2 months after the close of the plan year (normally this will be March 15), then the excess and the earnings are taxable to the participant in the year distributed. The federal income tax withholding rules apply to a correcting distribution after 2 1/2 months after the end of the plan year.

The de minimis rule also applies to excess aggregate contributions.

SPECIAL RULE – FAILING THE ADP AND/OR ACP TESTS AFTER A TOTAL DISTRIBUTION

A 401(k) plan may well make, in 2001, a total distribution to a 401(k) participant who is a highly compensated employee and then discover in 2002, when doing the ADP and/or ACP tests, that the tests are not satisfied.

The original 1099-R will need to be corrected. First, file a CORRECTED Form 1099-R for 2001 for the correct amount of the total distribution (not including the amount recharacterized as excess contributions or excess aggregate contributions). Second file a NEW Form 1099-R for 2001 for the excess contributions or the excess aggregate contributions plus the allocable earnings.

Under standard IRS procedures, there could well be a penalty assessed for filing the NEW forms 1099-R after the February 28th deadline. So that the IRS does not assess this penalty, the IRS suggests entering in the bottom margin of the Form 1096, Annual Summary and Transmittal of U.S. Informational Returns, the words, “Filed to Correct Excess Contributions.”

The plan administrator is required to furnish copies of the corrected new Form 1099-R to the former participant and explain why such new forms are being furnished. The plan administrator will want to inform the participant that if he or she rolled over the entire amount, then he or she will want to withdraw the amount shown on the NEW Form 1099-R (plus allocable income) since this amount is not eligible to be rolled over to an IRA.

EXCESS ANNUAL ADDITIONS UNDER CODE SECTION 415.

A plan administrator, at times, will need to make distributions of elective deferrals (and allocable earnings) and/or a return of employee after tax contributions (and allocable earnings) because tests show the section 415 annual additions limit is not being met because of an allocation of forfeitures, a reasonable error in estimating a participant’s compensation, or a reasonable error in determining the amount of elective deferrals that may be made for an individual under the limits of section 415.

Such distributions are subject to the federal income tax withholding rules under section 3405. They are not subject to the social security, medicare or FUTA taxes. They are not subject to the 10% additional tax under Code section 72(t).

Even though such distributions are subject to the withholding rules, they are still NOT eligible to be rolled over.

The plan administrator will need to report such distributions on Form 1099-R.

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If a Form 1099-R is not being generated that year for any other distributions, then the plan administrator may prepare just one Form 1099-R to report the distribution of the elective deferral (plus earnings) and the distribution of any employee contributions (plus earnings).

However, if the plan administrator made other distributions during the year, then they are to be reported on a separate Form 1099-R.

With respect to the distribution of elective deferrals (plus earnings), they are fully taxable (i.e. no part of the distribution is due to after-tax employee contributions). In this case, report the amount of the total distribution in boxes 1 and 2a; leave box 5 blank and enter Code E in box 7.

With respect to the distribution of employee contributions (plus earnings) enter the gross amount of the distribution in box 1, the earnings attributable to the employee contributions being returned in box 2a and the employee contributions being returned in box 5 and enter Code E in box 7.

In summary, this article has covered the procedures to be used by a qualified plan administrator to correct for either an excess deferral, an excess contribution, or an excess aggregate contribution.

The plan administrator is required to furnish an explanation at the time of the correcting distribution.

Generally, it will be best if all contributions are made by March 15 of the following year. ◆

Completing the 2001 Form 1099-R for 401(k) Distributions

The law was changed a few years ago so that distributions from qualified plans of less than $10.00 are not required to be reported to the participant and/or the IRS on the Form 1099-R. The IRS would still like Form 1099-R prepared for distributions of less then $10.00.

A qualified plan administrator must furnish the federal copies B and C of the 2001 Form 1099-R to the recipient by January 31, 2002. The administrator may file the print versions of Copy A with the IRS by February 28, 2002. If the administrator files electronically, then the due date is April 1, 2002.

A recipient of a distribution from a qualified plan, including a 401(k) plan, will need to complete his or her 1040 or 1040A with the amount of the gross distribution from the qualified plan, and also the taxable amount.

Set forth below is the 2001 Form 1099-R and a very brief summary of the boxes which are to be completed. Remember that in addition to distributions from 401(k) plans and other types of section 401(a) qualified plans, the Form 1099-R is used to report distributions from traditional IRAs, Roth IRAs, Coverdell ESAs and general annuities.

CWF's Explanation

Box 1. Gross Distribution.

Shows the total amount the participant or beneficiary received this year. This amount is reported on Form 1040 or 1040A on the line for "Total pension and annuities" unless this qualifies as a lump-sum distribution and you will be using Form 4972. Also report on this line corrective distributions of excess deferrals, excess contributions or excess aggregate contributions.

Box 2a. Taxable Amount

This part of the distribution is generally taxable.

If there no entry in this box, it means the payer felt it did not have all of the needed information to figure the taxable amount. If the annuity starting date is after 1997, the participant or beneficiary must use the simplified method to figure the taxable amount. See Publication 575, Pension and Annuity Income.

If a distribution is directly rolled over, a zero should be shown and the recipient must enter zero (0) on the taxable amount of his or her tax return.

If this is a total distribution from a qualified plan, and the recipient was born before January 1, 1936, or is the beneficiary of someone born before January 1, 1936, then he or she may be eligible to use the 10-year averaging option. The recipient will use Form 4972 to determine if he or she qualifies.

Box 2b. Taxable Amount Not Determined and Total Distribution

There are two checkboxes. They will be checked, if applicable.

The payer may have been unable to determine the taxable portion of the distribution. If so, it will check the "Taxable amount not determined" box. This should happen only rarely with respect to a 401(k) plan.

The payer will check this box if there was a total distribution which closed the account. In order to qualify for 10-year averaging treatment or capital gain treatment, the distribution must qualify as a lump-sum distribution. Not all total distributions will qualify as a lump-sum distribution, but the recipient will not be eligible for 10-year averaging or capital gain treatment unless there is special type of total distribution.

Box 3. Capital Gain (included in box 2a).

The recipient may be able to use a unique capital gain rule to determine the taxes owing on this amount. This special calculation is explained by Form 4972.

The recipient will be eligible only if he or she received a lump-sum distribution from a qualified plan and was born before January 1, 1936, or he or she was a beneficiary of someone born before January 1, 1936.

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9898 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code		1 Gross distribution $ 2a Taxable amount $	OMB No. 1545-0119 2001 Form 1099-R	Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.
		2b Taxable amount not determined ☐	Total distribution ☐	Copy A For Internal Revenue Service Center
PAYER'S Federal identification number	RECIPIENT'S identification number	3 Capital gain (included in box 2a) $	4 Federal income tax withheld $	File with Form 1096.
RECIPIENT'S name		5 Employee contributions or insurance premiums $	6 Net unrealized appreciation in employer's securities $	For Privacy Act and Paperwork Reduction Act Notice, see the 2001 General Instructions for Forms 1099, 1098, 5498, and W-2G.
Street address (including apt. no.)		7 Distribution code / IRA/ SEP/ SIMPLE ☐	8 Other $ %	
City, state, and ZIP code		9a Your percentage of total distribution %	9b Total employee contributions $	
Account number (optional)		10 State tax withheld $ $	11 State/Payer's state no.	12 State distribution $ $
		13 Local tax withheld $ $	14 Name of locality	15 Local distribution $ $

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

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Box 4. Federal Income Tax Withheld.

This is the amount of federal income tax withheld. The recipient will include this amount on his or her income tax return as an amount withheld. The recipient is instructed to include the Copy B with his or her tax return.

Box 5. Employee Contributions or Insurance Premiums

This is the amount of after-tax contributions which were distributed to the recipient this year. They are non-taxable.

Box 6. Net Unrealized Appreciation (NUA) in Employer's Securities

If the recipient did not receive a lump-sum distribution, then the amount shown is the NUA attributable to the employee's contributions, and there is no taxation until the securities are sold.

If the recipient did receive a lump-sum distribution from a qualified plan that includes employer securities, then the net unrealized appreciation (any increase in value of such securities while in the trust) is taxed only when the recipient sells such securities, unless an election is made to include it in income for the distribution year.

Box 7. Distribution Code and Box to Check if IRA/SEP/SIMPLE.

As is well known, the IRS uses codes to identify the reason and/or type of distribution which the recipient received. This code is primarily used by the IRS to determine if the 10% additional tax of Code section 72(t) applies to the distribution. But it has other purposes also. Set forth below is a listing of all such codes, with a brief description.

Unless stated otherwise, the Code may be used for distributions from qualified plans and IRAs.

The following explanations apply for tax year 2001. Because of EGTRRA, the IRS will be revising these explanations.

1. Early distribution, no known exception (in most cases, under age 59 1/2. Applies to distributions from a qualified plan or an IRA.

2. Early distribution, exception applies (under age 59 1/2). It must be an exception as defined Code section 72(q), (t) or (v).

   Applies to distributions from a qualified plan or an IRA. Many of the exceptions apply whether the distribution is from a qualified plan or an IRA. Other exceptions apply only to distributions from IRAs, and other exceptions apply only to distributions from qualified plans.

   If the payer inserts this code, then the recipient will not be required to complete and file the Form 5329.

3. Disability. Neither the IRS instructions to the payer nor the recipient define the term, "disability."

4. Death. Indicates a payment to the decedent's beneficiary, including an estate or a trust.

5. Prohibited Transactions. No guidance given by the IRS instructions.

6. Section 1035 Exchange. Does not apply to distributions from a qualified plan or an IRA.

7. Normal Distribution. To be used for a distribution to a participant who is at least age 59 1/2.

   Use with A (10-year averaging option),when applicable.

8. Excess contributions plus earnings, and excess deferrals and/or earnings taxable in 2001.

   This code is used extensively by both qualified plans and IRAs. The law's approach for a distribution from a qualified plan and an IRA are similar but not identical.

9. PS 58 costs. Is used to report the cost of the premiums paid by a qualified plan for a participant's current life or other insurance coverage.

   Not applicable for IRAs.

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A. May be eligible for 10-year Averaging Tax Option

Indicates that the distribution to the recipient is eligible for the 10-year averaging option method of computing the tax on a lump-sum distribution.

The payer is not required to consider this option if prior use of this method disqualifies the recipient.

D. Excess contributions plus earnings, and excess deferrals taxable in 1999.

As instructed by the IRS chart, look to the explanation for code 8.

E. Excess annual additions under section 415 and certain excess amounts under section 403(b) plans.

The IRS chart contains no guidance.

F. Charitable Gift Annuity. The IRS chart contains no guidance.

G. Direct Rollover to an IRA. This is probably the most often-used code for a distribution from a qualified plan.

H. Direct Rollover to a qualified plan or a 403(b) plan. This code is used for distributions from a qualified plan and also for distributions from a conduit IRA.

J. Early distributions from a Roth IRA, no known exception. Does not apply to distributions from a qualified plan.

L. Loans treated as deemed distributions under 72(p). This will be used fairly often by the administrator of a 401(k) plan, if that plan offers loans.

The IRS warns that code L is not needed to report a loan offset.

M. Distribution from a CESA. Does not apply to distributions from a qualified plan.

N. Recharacterized IRA Contribution made in 2001. Does not apply to distributions from a qualified plan.

P. Excess contributions plus earnings/excess deferrals taxable in 2000. The IRS explanation is to see the explanation for 8.

R. Recharacterized IRA Contribution made in 2000. Does not apply to distributions from a qualified plan.

S. Early distribution from a SIMPLE IRA in first 2 years, no known exception. Does not apply to distributions from a qualified plan.

T. Roth IRA distribution, an exception applies. Does not apply to distributions from a qualified plan.

Box 8. Other

If a lump-sum distribution included an annuity contract, then include the current actuarial value of such contract.

This value is not included in box 1 or box 2a.

The value is an amount equal to the current actuarial value of the annuity contract reduced by an amount equal to the excess of the employee's contributions over the cash and other property distributed, but not including the annuity contract.

If the annuity contract is part of a multiple lump-sum distribution, also enter the percentage of the total.

Box 9a Your Percentage of Total Distribution

For all non-annuity distributions, if the distribution was a total distribution and was paid to multiple recipients, then enter each recipient's percentage of the total distribution.

Box 9b Total Employee Contributions

Completing this box is optional. However, a recipient would certainly benefit from being provided this information.

The qualified plan administrator is not to include in "total employee contributions" any amounts previously recovered tax free in prior year. If there is a total distribution, then box 5 is to be used to report the total employee contributions, and not box 9b.

Box 10 State Tax Withheld. Optional and self-explanatory.

Box 11 State/Payers State No. Optional and self-explanatory.

Box 12 State Distribution. Optional and self-explanatory.

Box 13 Local Tax Withheld. Optional and self-explanatory.

Box 14 Local/Payers State No. Optional and self-explanatory.

Box 15 Local Distribution. Optional and self-explanatory.

In summary, completing the 2001 Form 1099-R for distributions from a 401(k) plan or other qualified plan is a

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little more involved than a distribution from an IRA. There are special rules that may apply: 10-year averaging, special capital gain rules, special rules for employer stock, and special rules for certain annuity distributions. Also, because of the mandatory nature of QP withholding, there tends to be more funds withheld from QP distributions than from IRA distributions. One can expect that the 1099-R will have substantial changes for 2002 because of EGTRRA. We will keep you informed. ◆

IRS Given Authority to Waive 60-Day Rollover Rule

As you are aware, funds distributed from an IRA or qualified plan may be rolled back into the account if the transaction takes place within 60 days of the distribution. If not, the distribution is taxable to the individual. Congress has now passed a law granting the IRS authority to, at its discretion (it is not required to), waive the 60-day rollover rule if enforcing it would cause the individual undue hardship. This authority becomes effective for distributions made after 12/31/01. The IRS could waive the 60-day rollover period if not to do so would be "against equity or good conscience, including casualty, disaster, or other events beyond the reasonable control of the individual subject to such requirement." Some types of hardships would be (1) a participant has received payment by check but has not cashed the check; (2) errors are committed by a financial institution; (3) death, disability, hospitalization, etc, which are beyond the individual's control. Although this is a step in the right direction, we believe that addressing just this one rule, when there are many rules governing a rollover, is not as helpful as it could be. There are times when accountholders could use relief from other rollover rules such as the "one-rollover-per-year" rule. For example, an IRA accountholder takes a distribution in January of 2002 and rolls it over in February of 2002. Then in May he takes a second distribution and wants to roll it over. Will the IRS use its new authority in this situation? This is not a per se violation of the 60-day rule. It is a violation of the once-per-twelve-month rule. Nevertheless, the IRS might choose to be generous and use its waiver authority.

In the above situation, would or should it make a difference if the accountholder had been put on notice that he was entitled to only do one rollover per year? Would it make a difference if the accountholder was told by an IRA custodian that certainly he could do more than one rollover per twelve months?

We think it would. If an individual can demonstrate to the IRS that he or she reasonably relied on someone else who caused him or her to miss the 60 day requirement or other rollover requirement, or that he or she was sick or had a family emergency, then we believe the IRS would grant the individual a waiver.

The individual must be able to demonstrate that his or her noncompliance with the rollover rules occurred for reasons beyond the control of the individual. That is, somehow the individual must show that they are not at fault.

Special Procedures. It will not be long before some individuals will need to see if the IRS will waive the 60-day rule with respect to a rollover which they want to do. One should not assume the IRS will always issue a waiver.

An IRA custodian should advise a customer or prospective customer that he or she will need to obtain a waiver from the IRS. It will GENERALLY be the responsibility of the individual or his or her tax advisor to obtain the written waiver. The exception is – if the personnel of the IRA custodian gave improper information which contributed to the failed rollover, then the IRA custodian may wish to assist in obtaining the waiver.

We would suggest that an IRA custodian may choose from two approaches. This first approach is the most conservative approach.

The fist approach is to not accept the rollover deposit until the IRA accountholder furnishes the IRS' written authorization waiving the 60-day requirement.

The second approach is to accept the rollover contribution on the condition that the IRS waiver will be obtained and furnished to the IRA custodian on or before the tax-filing deadline for the year the questionable rollover is made. If it is not obtained, the depositor agrees to withdraw the purported rollover as an excess contribution. The individual would agree to hold the IRA custodian harmless if, for some reason the excess distribution was not paid out on or before the tax-filing deadline plus extensions.◆

Is a Tax Mess Coming?

Differences in Federal and State IRA Tax Laws

EGTRRA was signed into law on June 7, 2001. It changed the contribution limits for IRAs for 2002 federal income tax purposes to $3,000/$3,500. In order for such limits to apply to those states which have income taxes, a state will need to adopt such changes. Some states such as Minnesota already have. At this time we have not determined which states with income taxes have adopted the new limits. We will do so soon and cover it in a subsequent newsletter.

Some or many states may choose to NOT adopt the IRA changes and other changes made by EGTRRA. A state certainly has the right to NOT adopt the IRA and/or other EGTRRA law changes. Many states may decide that they cannot afford to lose the tax revenues which would occur if all of the IRA changes and/or the pension plan changes

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would be adopted.

States (or at least those working in the tax departments) understand well the administrative tax problems which arise when they have tax rules which differ from federal tax rules. A state and its residents and those required to filed a state income tax return will have substantial tax administrative problems if such changes are not adopted.

The purpose of this article is to present an overview of some of the tax issues which will may arise if a state does not go along with the EGTRRA changes for IRAs. We believe that individuals will want to and will make the larger contributions even though they may not receive as favorable treatment under their state law. The federal tax benefits are that great.

Here is a listing of various questions which will need to be addressed if an individual contributes in 2002 D,000 or $3,500, as applicable, when state law only authorizes a tax deduction of $2,000? The following types of questions will need to be answered for both traditional and Roth IRAs and for Coverdell Education Savings Accounts.

1. Will state law impose an excess contributions tax on the amount in excess of $2,000?
2. If the answer to (1) is "yes", then what would be percentage rate and the amount of the tax?
3. Would this excess contributions tax be an annual tax and continue to accumulate for subsequent years?
4. When funds are distributed in future years from the traditional IRA, what method will be used to determine the taxable and nontaxable portions of the distributions?
5. Is the income being earning within the IRA entitled to not be taxed under state law or should it pay tax now?

We expect those states which do not adopt the EGTRRA changes for IRA contribution limits to at least change state law so that a person will not be penalized for contributing more than $2,000. However, a state with respect to traditional IRAs may well choose to not allow the additional amount to be deducted for state income tax purposes and in the case of a Roth IRA would not allow the income accumulated with respect to the additional contribution amount in the Roth IRA to be tax free.

We do expect the EGTRRA rollover changes will be adopted by the states because to do otherwise would bring such complexity and uncertainty about tax results that one cannot imagine it happening.

We will furnish a summary of the various state laws in the near future.

It will be primarily the responsibility of the individual to understand and comply with state laws which differ from federal laws. Under federal law there is no requirement to discuss state laws in the IRA plan agreement or the IRA disclosure statement.

An IRA custodian/trustee may want to consider furnishing a separate disclosure of state laws and income tax consequences and adopt one of two approaches. The first approach would be to explain the state rules. There would also be the question of how thoroughly to explain the state laws. The second approach would be to include a generic statement that the IRA accountholder will need to consult with his or her own tax advisor as to the state law. ◆

Favorable Letters,
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This time the IRS is not going to allow employers to wait so long to amend their plan. The IRS has settled on an "interim" approach. The IRS has decreed that each qualified plan must adopt an EGTRRA "good faith" amendment on or before December 31, 2002. This amendment will last until 2005, when again there will be the requirement that prototype adopters again sign the adoption agreement of a plan incorporating all changes for the period of 2001-2005.

The good new is – financial institutions will now be able to furnish its business customers with the GUST prototype (adoption agreement and basic plan document) and the EGTRRA amendment at the same time. Hopefully, this will allow you to more efficiently serve your business customers.

The bad news is – you will have to obtain your customer's signatures on both the GUST document and the EGTRRA good faith amendment.

We would recommend that you try to obtain these signatures by June 15, 2002.

It may take some time, but the pension changes authorized by EGTRRA are so large in the sense that they grant such large tax deductions, that it will not take long for all employers (large, medium and small) to start to adopt and contribute to these plans much more than they have in the past. All that is needed are the "profits." Some of the more radical changes are: (1) the deduction limit for profit sharing plans is now 25% of compensation; (2) self-employed individuals will be able to borrow from their profit sharing plan; (3) the elective deferral limits have been increased: (4) catch-up contributions may now be made to a 401(k) plan; certain individuals may not qualify for a tax credit because of the elective deferral which they make to a 401(k) plan; and a self-employed person may now have their own 401(k) plan.

We at CWF will be furnishing you with ordering and training information within the very near future. ◆

IRS Issues 2002 COLAs

IRS Announces Cost-of-Living Adjustments for 2002
The IRS in News Release 2001-115 Released its 2002 Adjustments as Follows:

	2000	2001	2002
Taxable Wage Base — OASDA Only	$76,200	$80,400	$84,900
SEP and Qualified Plan Maximum Compensation Cap – 401(a)(17) & 404(e)	$170,000	$170,000	$200,000
Elective (Salary) Deferral Limit – 401(k) & SAR-SEP	$10,000	$10,500	$11,000
Elective Deferral Catch-up Limit	N/A	N/A	$1,000
SIMPLE Deferred Limit – 408(p)(2)(A)	$6,000	$6,500	$7,000
SIMPLE Catch-up Limit	N/A	N/A	$500
Highly-Compensated Employees (Compensation as Indexed) New Definition as of January 1, 1997	$80,000	$85,000	$90,000
Defined Benefit Limit – Section 415(b)(1)(A)	$135,000	$140,000	$160,000
Defined Contribution Limit – Section 415(c)(1)(A)	$30,000	$35,000	$40,000
SEP Minimum Compensation Threshold – 408(k)(2)(c)	$450	$450	$450

Social Security COLA Increases

	2002	2001	INCREASE
Taxable Wage Base – OASDA Only (6.2%)	$84,900	$80,400	$4,500
Tax Amount Paid by the Employee	$5,264	$4,985	$279
Tax Amount Paid by the Employer	$5,264	$4,985	$279
Average Monthly Benefit	$874	$852	$23
Maximum Monthly Benefit	$1, 660	$1,536	$124
Amount of Earnings Exempt for Individuals Age 62-64	$11,280	$10,680	$600
Amount of Earnings Exempt for Individuals for the Year Age 65 but Only for Months Prior to Attaining Age 65	$30,000	$25,000	$5,000
Amount of Earnings Exempt for Individuals Age 65-69	None	None	None