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Deadlines Approaching

As you are aware, beginning October 1, 2002, revised plan documents must be used to open IRAs. Old documents are no longer in compliance. Revised documents contain all the new rules enacted under EGTRRA. As you know, these new rules are very beneficial to your IRA customers.

Another deadline is approaching concerning the furnishing of comprehensive amendments to existing accountholders. Amendments to existing IRA accountholders must be furnished by December 31, 2002. The IRS can impose a fine of $50 per account for failure to furnish this amendment.

CWF has revised many of our brochures in order to help your customers understand how the changes affect their accounts.

Please call our sales department if you desire to order or want further information concerning revised plan agreements, amendments, or brochures.

Were the Roth IRA Withholding Rules Repealed?

CWF believes the withholding rules for distributions from Roth IRAs were practically repealed, if not repealed in fact.

On December 21, 2000, President Clinton signed the Consolidated Appropriations Act of 2001 (P.L. 106-554). This Act was a large appropriations act, but it contained a number of technical corrections to the Internal Revenue Code. One of those technical corrections was set forth in section 314(b) which amended the last sentence of Code section 3405(e)(1)(B) by changing it to read as follows. "For purposes of clause (ii), any distribution or payment from or under an individual retirement plan (other than a Roth IRA) shall be treated as includible in gross income." The change was the insertion of "(other than a Roth IRA). "

Because this was a technical correction, it was made retroactively effective as of January 1, 1998. The retroactive effective date of this law change was clearly meant to coordinate with the date Roth IRAs first became effective (tax years beginning after 12/31/97).

Summary of the Roth Withholding Rules Prior to Change.

The last sentence of Code section 3405(e)(1)(B) had the effect that any distribution from a traditional IRA or Roth IRA was included in income for withholding purposes and tax reporting purposes. If you have ever wondered why the IRS in the instructions for completing form 1099-R has instructed the IRA custodian to complete box 1 (gross amount) and box 2a (the taxable amount) with the same amount, this last sentence was and is the authority for this treatment. The task then falls on the accountholder or beneficiary to complete the Form 8606 to demonstrate that portion of the distribution which is nontaxable because it is the return of basis (i.e. nondeductible contributions).

This last sentence also meant that the withholding rules applied to distributions from either a traditional IRA or a Roth IRA.

The IRS adopted a final Roth IRA regulation on February 2, 1999, and the regulation provided that the withholding rules applied to a Roth IRA distribution-Q/A-12 of Regulation 1.408A-6

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(Distributions) provided that "distributions from a Roth IRA are distributions from an IRA for purposes of section 3405 and thus are designated distributions unless one of the exceptions in section 3405(e)(1) applies." The Roth IRA custodian is required to withhold at the 10% rate unless the individual elected to have no amount withheld.

As will be discussed below, with hindsight it appears that the IRS adopted rules and procedures which did not require the Roth IRA custodian to implement the withholding rules with respect to Roth IRA distributions.

Summary of the Roth Withholding Rules After the Law Change

With the enactment of the technical correction in December of 2000, an argument can be made that this last sentence has the effect that any distribution from a Roth IRA by definition shall NOT be included in gross income. This would mean that the withholding rules no longer apply to a distribution from a Roth IRA because BY DEFINITION the Roth IRA custodian is allowed to treat the entire distribution as not being includible in gross income.

Even if this argument is not adopted, the Roth IRA custodian will be able to rely on the exception provided by section 3405(e)(1)(B)(ii) since, in almost all cases, it will be reasonable to believe that the distribution is not includible in gross income.

We believe the purpose of this technical correction was to formally conform the law to the withholding rules and procedures with respect to a Roth IRA distribution which the IRS had adopted and implemented since 1998. The IRS has always required the Roth IRA accountholder or beneficiary to determine and report the taxable portion of a Roth IRA distribution on the Form 8606. In a consistent fashion, the IRS has never required the Roth IRA custodian to complete box 2 (the taxable amount) on the Form 1099-R. Rather, the IRS has always instructed the Roth IRA custodian to leave this box blank unless there has been a recharacterization or withdrawal of an excess contribution. And now the Internal Revenue Code has been changed so that the duties of the Roth IRA custodian with respect to preparing the Form 1099-R and performing withholding duties will be consistent. It made no sense for the IRS to instruct an IRA custodian that it was not required to determine the taxable portion of a Roth IRA distribution for Form 1099-R reporting purposes, but then require the Roth IRA custodian to determine the income portion for withholding purposes. This was a good, common sense change.

Additional Discussion.

Roth IRAs were first authorized by the Taxpayer Relief Act of 1997, and applied to tax years beginning on or after January 1, 1998. Code section 408A(a) provides the rule that a Roth IRA must comply with the same rules which apply to a traditional IRA except where the Internal Revenue Code specifies a different treatment. Code section 3405(e)(1)(B), as discussed above, has been retroactively revised to require different withholding treatment for traditional IRAs and Roth IRAs.

Obviously, a financial institution acting as a traditional and/or Roth IRA custodian wants to perform all of its duties under the withholding rules so that it has no liability. But an institution also does not want to be so intimidated by the withholding rules that it takes on tasks and expenses not required by the rules.

The withholding rules apply to a distribution from a traditional IRA and a Roth IRA only if the distribution is a designated distribution. A distribution from a traditional IRA is a designated distribution, and thus the Form W-4P or a substitute form must be furnished. A distribution from a Roth IRA is NOT a designated distribution, and thus the Form W-4P or a substitute form is NOT required to be furnished. In fact, we believe a Roth IRA custodian could have serious compliance problems if it instructs the Roth IRA recipients that the withholding rules apply to the distribution. Presumably, a Roth IRA custodian could decide to voluntarily perform the withholding duties, but special disclosure and administrative forms would need to be created. A Roth IRA distribution form should no longer state that the withholding rules apply as a matter of law.

The withholding rules amount to (1) furnishing an initial notice; (2) generally withholding at the rate of 10% unless the recipient instructs to withhold more or nothing; and (3) furnishing the annual withholding notices, if required.

Since 1998, the IRS has acknowledged that the Roth IRA custodian does not have the duty to determine the portion of a distribution from a Roth IRA includible in the recipient's in taxable income. The instructions for the Form 1099-R for 1998-2002 have always stated that Box 1 (the gross amount of the distribution) must be completed, but Box 2a (the taxable amount) is to be left BLANK. The IRS has adopted this approach because of the Roth IRA taxation rules which require that all Roth IRAs be aggregated, and the rules which define the order of distributions (annual contributions, conversions, and then income). The only way a Roth IPA custodian could determine if a Roth IRA distribution was "taxable" would be to have the prospective recipient complete a list of questions which would generally require the help of his or her accountant. Theoretically, if the accountholder has had his or her Roth IRAs only with one financial institution, then the taxable portion of a Roth IRA distribution could be determined if one examined in detail the file(s). We don't believe the IRS has or will ever adopt such a burdensome rule.

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For the last four years (1998-2001) the following provision has been in the IRS Publication 590 concerning traditional IRAs: "Withholding. Federal income tax is withheld from distributions from traditional IRAs unless you choose not to have tax withheld. This provision clearly applies only to distributions from a traditional IRA. CWF believes the IRS would have mentioned Roth IRAs if the withholding rules applied to Roth IRAs. There is no such discussion of withholding in the section of Publication 590 which applies to Roth IRAs. There has also been no description of how and why the withholding rules apply to Roth IRA distributions. We believe the IRS would have expressly used the term, "Roth IRA" if distributions from such plans were subject to the withholding rules.

And it has not been clear in the Form W-4P whether the form covered distributions from Roth IRAs. For the last four year (1998-2001) the IRS, in the Form W-4P, has included the following paragraph.

Withholding From Pension and Annuities

"Generally, Federal income tax withholding applies to the taxable part of payments made from pension, profit-sharing, stock bonus, annuity, and certain deferred compensation plans; from individual retirement arrangements (IRAs); and from commercial annuities."

It was not clear if IRAs covered only traditional IRAs or traditional IRAs and Roth IRAs. It now looks like the IRS meant to cover only traditional IRAs.

Conclusion

The IRS has adopted rules and procedures indicating that the withholding rules do NOT apply to Roth IRA distributions. The instructions for the Form 1099-R and Form W-4P clearly indicate that it is reasonable for the Roth IRA custodian to NOT determine the portion of a distribution which is includible in gross income for taxation and withholding purposes. The IRS Publication 590 does not indicate that the withholding rules apply to Roth IRA distributions.

We would think that Roth IRA custodians and service providers would welcome this change. Roth IRA custodians have sufficient work without taking on work which the IRS has not indicated is required. The IRS has not designed the reporting and withholding rules to cover that rare Roth IRA distribution situation where the Roth IRA custodian would have all the necessary tax facts to know that a portion of the distribution would need to be included in income. The IRS has been very reasonable in adopting consistent rules and procedures which place the duty of determining the tax consequences of a Roth IRA distribution on the recipient and his or her tax advisor.

Amending SEP-IRA, SAR-SEP and SIMPLE-IRA Plans and Related IRAs and SIMPLE-IRAs

The purpose of this article is to discuss the rules and procedures governing the amending and restating of SEP-IRA plans and SIMPLE-IRA plans. In general, there will always be two steps involved in such amendment process. First, the sponsoring business entity will be required to complete and sign the applicable IRS model form. Secondly, the financial institution serving as the custodian/trustee of an eligible employee's SEP-IRA or SIMPLE-IRA will be allowed to mail a comprehensive SIMPLE-IRA amendment to the employee, and the person is not required to sign this amendment for it to become effective.

The procedures for each type of plan are discussed separately.

Amending the SEP-IRA Plan for One-Person Businesses Using the IRS Model Form 5305-SEP

A SEP-IRA plan is established when the self-employed person executes a SEP plan document and establishes a traditional IRA. For purposes of this article, it is assumed the person has used the most recent version of the IRS Model Form 5305-SEP (March of 2002) to establish the SEP-IRA plan. Amending such a SEP-IRA plan is a two-step process.

The self-employed person is the party responsible to amend his or her SEP-IRA plan. Remember that the form 5305-SEP does not have a place for the financial institution to sign. The only signer of this form is the employer, who, in this situation, is the self-employed person. A financial institution, however, for customer service reasons, may wish to make it easy for your self-employed clients with SEP-IRA plans to amend such plans. In order to be able to take advantage of the new deduction limit which is the lesser of 25% of compensation or $40,000, the self-employed person must adopt or sign the March 2002 version of form 5305-SEP.

You will want to furnish the self-employed person with two forms. One form he or she will need to sign and the other he or she will not need to sign as discussed below.

Step one is simple. The IRA custodian is allowed to mail a comprehensive traditional IRA amendment to the self-employed person. The person is not required to sign this amendment for it to become effective. If your institution uses CWF forms, this amendment will be one of our custodial amendment forms 74-TC or 75-TC), trust amendment forms (74-TT or 75-TT) or custodial self-directed amendment forms (74-SD or 75-TSD).

Unfortunately, step two is not so simple. The IRS has, in prior years, required an employer to amend and restate its

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employer-sponsored pension plan, whether it be a defined benefit pension plan, 401(k) plan, profit sharing plan or SEP-IRA plan, by signing a revised and updated plan document. We don't believe the IRS has adopted a different rule just because the employer is a self-employed person even when there are no other employee participants. An IRA custodian will want to furnish the most recent version of the IRS Model Form 5305-SEP to the self-employed person so that he or she may execute it. One copy should be returned to you as the IRA custodian. CWF sells this form in carbonless format. It is our form #700.

Amending the SEP-IRA Plan for Multiple Participants

Of course, the procedures to amend a multiple-participant plan are very similar to those for a one person plan.

The business (be it a corporation, partnership or self-employed person) must execute the March 2002 version of the IRS Form 5305-SEP. A copy of such form must be furnished to each eligible employee.

The IRA custodian will need to furnish the standard comprehensive amendment to each eligible participant who maintains a standard traditional IRA to receive his or her SEP-IRA contributions. The IRA custodian is allowed to mail a comprehensive traditional IRA amendment to each participant/accountholder The person is not required to sign this amendment for it to become effective. If your institution uses CWF forms, this amendment will be one of our custodial amendment forms (74-TC or 75-TC), trust amendment forms (74-TT or 75-TT) or custodial self-directed amendment forms (74-TSD or 75-TSD).

Amending the SAR-SEP IRA Plan With Multiple Participants Using the IRS Model Form 5305-A SEP

A SAR-SEP is a special type of SEP plan which allowed the employees of certain businesses to make elective deferrals as employees do under a 401(k) plan. The law was changed in 1996 so that a SAR-SEP plan may not be established after 1996. If an employer established a SAR-SEP before 1997 that authorized elective deferrals, such an employer was allowed to continue its SAR-SEP plan for years after 1996. In order to be able to take advantage of the new deferral limits and the new deduction limit (the lesser of 25% of compensation or $40,000), the business must adopt or sign the March 2002 version of form 5305-SEP.

A SAR-SEP IRA plan is established when the sponsoring business executes a SAR-SEP plan document and establishes a traditional IRA. For purposes of this article, it is assumed the sponsoring business has used the prior version of the IRS Model Form 5305A-SEP to establish the SAR-SEP IRA plan. Amending such a SAR-SEP IRA plan is a two-step process.

Step one. The business (be it a corporation, partnership or self-employed person) must execute the March 2002 version of the IRS Form 5305-SEP. A copy of such executed form (and the instructions) must be furnished to each eligible employee.

Step two. The IRA custodian is allowed to mail a comprehensive traditional IRA amendment to each participant/accountholder. The accountholder is not required to sign this amendment for it to become effective. If your institution uses CWF forms, this amendment will be one of our custodial amendment forms (74-TC or 75-TC), trust amendment forms (74-TT or 75-TT) or custodial self-directed amendment forms (74-SD or 75-TSD).

Amending a SIMPLE-IRA Plan for a One-Person Business Using the IRS Model Form 5304-SIMPLE

A SIMPLE-IRA plan is established when the self-employed person executes a SIMPLE-IRA plan document and establishes a traditional IRA. For purposes of this article, it is assumed the person has used a prior version of the IRS model form 5304-SIMPLE to establish the SIMPLE-IRA plan. Amending such a SIMPLE-IRA plan is a two-step process.

Step one. The person, in his or her role of being the employer, must sign the March 2002 version of the Form 5305-SIMPLE. The self-employed person is the sole party responsible to amend his or her SIMPLE-IRA plan when he or she has the Form 5304-SIMPLE, since there is no designated financial institution. The employer signs this form and the financial institution does not. The IRS has, in prior years, required an employer to amend and restate its employer-sponsored pension plan, whether it be a defined benefit pension plan, 401(k) plan, profit sharing plan or SIMPLE-IRA plan by signing a revised and updated plan document. We don't believe the IRS has adopted a different rule just because the employer is a self-employed person, even when there are no other employee participants. A financial institution will want to furnish the most recent version of the IRS Model Form 5304-SIMPLE to the self-employed person so that he or she may execute it. One copy should be returned to you as the custodian of the person's SIMPLE-IRA. CWF sells the Form 5304-SIMPLE in carbonless format. It is our form #917A.

Step 2. The SIMPLE-IRA custodian is allowed to mail a comprehensive SIMPLE-IRA amendment to the self-employed person. Special note – unlike the SEP IRA which uses a traditional IRA to receive the SEP-IRA contributions, there is a special SIMPLE-IRA form to receive the SIMPLE-IRA contributions. The person is not required to sign this amendment for it to become effective. If your institution uses CWF forms, this SIMPLE-IRA amendment will be one of our comprehensive SIMPLE-IRA amendments – custodial amendments forms (74SC or 75SC), trust amendment forms

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(74ST or 75ST) or custodial self-directed amendment forms (74SSD or 75SSD).

Amending a SIMPLE-IRA Plan for a One-Person Business Using the IRS Model Form 5305-SIMPLE

The procedures to be used to amend a SIMPLE-IRA established by use of the IRS model Form 5035-SIMPLE are slightly different because there is a designated financial institution. Two parties originally signed the previous form 5305-SIMPLE – the person in his or her role of being the employer and the financial institution in its role of being the designated financial institution. Both parties will need to execute the March of 2002 version.

Step one. A financial institution will want to furnish the March of 2002 version of the IRS Model Form 5305-SIMPLE to the self-employed person so that he or she may complete it, and then both parties will need to sign it. There is little doubt that the individual as the employer is primarily responsible to amend his or her SIMPLE-IRA plan. However, you should furnish this revised form as a client service. One copy should be retained by you as the custodian of the person's SIMPLE-IRA. CWF sells the Form 5305-SIMPLE in carbonless format. It is our form #917.

Step two. The SIMPLE-IRA custodian is allowed to mail a comprehensive SIMPLE-IRA amendment to the self-employed person. The procedures are the same as they are when the Form 5304-SIMPLE-IRA form is used. The person is not required to sign this amendment for it to become effective. If your institution uses CWF forms, this amendment will be one of our custodial amendment forms (74-SC or 75-SC), trust amendment forms (74-ST or 75-ST) or custodial self-directed amendment forms (74-SSD or 75-SSD).

Amending the SIMPLE-IRA Plan With Multiple Participants Using the IRS Model Form 5304 SIMPLE

Step One. The same procedures discussed above for the one-person business apply to the plan with multiple participants. The business (be it a corporation, partnership or self-employed person) must execute the March 2002 version of the IRS Form 5304-SIMPLE. A copy of such form and the instructions must be furnished to each eligible employee. If a revised Summary Description has not yet been furnished to each eligible employee, then this will need to be done also. A financial institution will want to furnish the most recent version of the IRS Model Form 5304-SIMPLE to the business so that it may execute it. One copy should be returned to you as the custodian of the person's SIMPLE-IRA. CWF sells the Form 5304-SIMPLE in carbonless format. It is our form #917A

Step Two. The SIMPLE-IRA custodian is allowed to mail a comprehensive SIMPLE-IRA amendment to each participant who maintains his or her SIMPLE-IRA with it. The SIMPLE-IRA accountholder is not required to sign this amendment for it to become effective. If your institution uses CWF forms, this amendment will be one of our SIMPLE-IRA custodial amendment forms (74-SC or 75-SC), trust amendment forms (74-ST or 75-ST) or custodial self directed amendment forms (74-SSD or 75-SSD).

Amending the SIMPLE-IRA Plan With Multiple Participants Using the IRS Model Form 5305-SIMPLE

The major difference for this situation is that a financial institution is acting as the designated financial institution.

Step One. The same procedures discussed above for the one-person business apply to the plan with multiple participants. The business (be it a corporation, partnership or self employed person) must execute the March 2002 version of the IRS Form 5305-SIMPLE. A copy of such executed form and the instructions must be furnished to each eligible employee. If a revised Summary Description has not yet been furnished to each eligible employee, then this will need to be done also. A financial institution will want to furnish the most recent version of the IRS Model Form 5305-SIMPLE to the business so that it may execute it. One copy should be returned to you as the custodian of the person's SIMPLE-IRA. CWF sells the Form 5304-SIMPLE in carbonless format. It is our form #917-A

Step Two. The SIMPLE-IRA custodian is allowed to mail a comprehensive SIMPLE-IRA amendment to each participant who maintains his or her SIMPLE-IRA with it. The SIMPLE-IRA accountholder is not required to sign this amendment for it to become effective. If your institution uses CWF forms, this amendment will be one of our SIMPLE-IRA custodial amendment forms (74-SC or 75-SC), trust amendment forms (74-ST or 75-ST) or custodial self directed amendment forms (74-SSD or 75-SSD).

MANDATORY – FURNISH REVISED SIMPLE-IRA FORMS FOR 2003 BEFORE OCTOBER 1, 2002

This is a reminder article. The maximum elective deferral amounts for 2003 will not be what they are for 2002. The amount for 2002 is $7,000 if the eligible employee is not age 50 by December 31, 2002, and is $7,500 if he or she is age 50 or older. The amount for 2003 is $8,000 if the eligible employee is not age 50 by December 31, 2002, and is $9,000 if he or she is age 50 or older.

An employer, in addition to amending its SIMPLE-IRA and furnishing copies of the applicable form to each eligible employee, will need to furnish its eligible employees various administrative forms as revised for

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**Revised SIMPLE-IRA Forms,
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2003. Why? An employer must comply with the following two rules.

Rule #1. For a calendar year (e.g. 2003), an eligible employee is able to make or modify his or her salary reduction election during the 60-day period immediately preceding January 1 of that year. For 2003 purposes this period runs from November 2 to December 31, 2002.

Rule #2. An employer must notify eligible employees within a reasonable period of time before the applicable 60-day election period that they can make or change salary-reduction elections. An employer should give the notice between September 15-November 1 so that it is sure to meet the "reasonable" notification requirement. In this notification, the employer must indicate whether it will provide a matching contribution or the nonelective contribution equal to 2 percent of each eligible employee's compensation. Employees must be notified that the employer will make a matching contribution equal to an employee's salary reduction contributions up to a limit of 3 percent of his or her compensation, or, alternatively, at a rate of 1-3 percent of compensation if the employer is eligible. In addition, the employer must provide a summary description for 2003. Failure to provide this information will subject the employer to a penalty of $50 per day until the notification is provided. This penalty will not be imposed if an employer can show that its failure to furnish the notice was due to reasonable costs.

CWF has updated the following forms:

#918 – SIMPLE-IRA account summary for 2003 (5305 version); #918-A – SIMPLE-IRA account summary for 2003 (5304 version); #970 – SIMPLE Elective Deferral instruction for 2003 (5305 version); #970-A – SIMPLE Elective Deferral instruction for 2003 (5304 version)

A SIMPLE-IRA custodian will want to remind its business customers with SIMPLE-IRA plans of these notice requirements.

In addition, a SIMPLE-IRA custodian may wish to remind its business customers that October 1, 2002, is the general deadline for an employer which has never sponsored a SIMPLE-IRA plan to establish such a plan for the 2002 calendar year.

SIMPLE Plan Termination

CWF has been asked the question, "Is it permissible to terminate a SIMPLE during the calendar year?," along with "If the employer wishes to quit funding the SIMPLE, must the plan be terminated?" The answers to these questions are "No," and "Yes," respectively.

Currently, the IRS does not provide anything in writing concerning the termination of a SIMPLE plan. There is no discussion of terminating a SIMPLE IRA plan in Model Form 5305-SIMPLE, Form 5304-SIMPLE, Publication 590, or Publication 560. CWF believes the only way a SIMPLE can be terminated is to notify employees more than 60 days prior to the calendar year for which the termination would be effective.

Because the employer and employees have determined the matching contribution percentage and elective deferral amounts, respectively, 60 days prior to the beginning of the next calendar year, the employer must follow through with its commitment for the entire calendar year. In fact, CWF believes that employees would have a legitimate claim against the employer if the employer would go out of business during the year and did not contribute the promised amount to its employees.

Can an employer quit funding the SIMPLE for a year or more without terminating the plan? The answer to this question is "No." The instructions for the 5304 or 5405-SIMPLE state that an employer must normally match employee deferrals up to 3% of compensation. However, in two out of five years, the employer is allowed to contribute a lesser percentage which can be anything between 1% and 3% of compensation. The intent to contribute a lesser amount must be indicated to the employees on the 60-day notice given prior to the calendar year for which the lower contribution percentage will apply. Contributing less than 1% is not authorized by the form.

How does the two-year participation requirement affect plan termination? The rule is that SIMPLE funds are not eligible to be rolled over or transferred by an employee until that individual has been a participant in the SIMPLE for a period of two years. This rule would not be changed even though an employer would terminate the plan. The employee would have to keep the funds in his or her SIMPLE-IRA (IRS Model Form 5305-S or 5305-SA) until the two-year requirement was met before the funds would be eligible to be rolled over or transferred. However, the individual may transfer or roll over the funds to another SIMPLE-IRA.

For an employer to be able to establish and fund a SIMPLE, the employer must not make any contributions to any other qualified pension plan for the benefit of any

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employees who are covered under the SIMPLE (including SEPs, 401(k) plans, etc.) during the same calendar year, for service in the same calendar year, for which the employer would contribute to the SIMPLE.

CWF has also had questions concerning changing from a SIMPLE 401(k) to a SIMPLE-IRA. Again, this cannot be done during a calendar year. Because these are two distinct plans, the funds cannot be simply moved from one plan to the other, and the plan cannot simply be renamed to be the other type. Also remember that the only retirement funds which are eligible to be rolled into a SIMPLE-IRA are other SIMPLE-IRA funds. SIMPLE 401(k) funds are not eligible to be rolled into a SIMPLE-IRA.

Offering Simplified Employee Pension (SEP) Plan Services

The purpose of this article to explain that it is extremely easy for a financial institution to offer SEPs. SEPs have few administrative requirements, they allow a much larger contribution than an IRA, and there is no age 70 1/2 requirement. We believe that with these advantages, financial institutions should seek to market these accounts.

To establish a SEP, an employer merely has to execute a SEP plan document, and each eligible employee must have their own traditional IRA account. An employer then deposits its contribution into each employee's IRA.

There are three ways an employer can offer a SEP plan to its employees:

1. Execute IRS Form 5305-SEP. There is no charge to do this. Under this form, the employer must do business on a calendar-year basis, and the contribution must be given to employees pro rata based on compensation.

2. Execute a SEP prototype as written by a pension consulting firm such as CWF. Under a prototype, the employer may do business on a fiscal-year basis, if desired, and a prototype plan allows integration with Social Security, which allows highly-compensated employees to receive a slightly higher contribution than the non-integrated IRS SEP Form. The prototype is also usually packaged to look more professional, if your institution intends to seriously market this product.

3. Have an individually designed plan prepared by an attorney. The cost for IRS review of such a plan is very high, and there really is no need for this type of SEP.

The IRS has mandated that revised SEP prototypes must be submitted to the IRS by 12/31/02. CWF will soon be submitting our revised document.

For one-person plans, instead of amending, an employer would have the option of merely completing the IRS Form 5305-SEP. There would be no filing fees involved in doing that. The deadline to switch from a prototype plan to the IRS form is 12/31/02.

One point an institution wants to make clear to an employer is that the financial institution is <u>merely the depository for the funds</u>, it <u>does not</u> offer investment or administrative advice — that's what legal and tax advisors are for. The customer must understand that the institution offers only limited retirement advice. This greatly limits the liability your institution has in regard to such deposits.

Original Intent of IRAs Has Changed

When IRAs were first introduced, the purpose was to provide solely for the accountholder's retirement. Even though, in the event of the accountholder's death, his/her beneficiaries would benefit, the account was intended for the sole use of the accountholder.

With the advent of the changes in the IRS rules and regulations, a new intent seems prevalent — the intent to provide for other family members in a variety of ways, as detailed below.

First-time Home Buyer— IRA funds can now be used to pay the qualified acquisition costs of the principal residence of a first-time home buyer. The person who uses IRA funds for this purpose can be the accountholder, his/her spouse, children, grandchildren, or any ancestor of either the accountholder or his/her spouse.

Education Expenses — Education expenses for the accountholder, the accountholder's spouse, children, or grandchildren can now be paid with IRA funds. These expenses include tuition, fees, books, supplies, and equipment required for enrollment or attendance at an eligible education institution.

Medical Expenses and Health Insurance Premiums — IRA funds may also now be used to pay certain medical expenses and health insurance premiums of the accountholder and anyone eligible to be claimed as a dependent by the accountholder on his/her income tax

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return. These expenses must exceed 7.5% of the accountholder's gross income. In other words, the expenses must qualify as an itemized deduction on the accountholder's income tax return.

QA

QUESTIONS AND ANSWERS

Question: An IRA accountholder died on March 2, 2002, prior to his required beginning date for his traditional IRA. The individual's beneficiary will be electing the 5-year payout option. Can the beneficiary take a distribution in 2002, and, if the distribution is permissible, will the distribution need to be included in the gross income of the beneficiary for 2002?

Answer: Yes, the beneficiary may take a distribution in 2002. Under the 5-year payout option, the rule is that the IRA account must be closed out no later than 12/31 of the 5th year after the year of death. In other words, the account must be closed by 12/31 of the year containing the 5th anniversary of the death. In this case that would be 12/31/2007. Note that the time period for payout may end up being longer than 5 years if, as in this case, the accountholder died early in the year. Because the accountholder died on March 2, 2002, there would actually be 5 years and 9 months in which to remove the total IRA balance. The timing and amount of distribution can be varied as desired by the beneficiary, as long as the deadline for total payout is met.

The distribution will most likely have to be claimed as income. The IRA beneficiary assumes whatever tax character the decedent would have had concerning the IRA funds. If the funds would have been taxable to the decedent, they would be taxable to the beneficiary. An example of such funds would be the normal deductible IRA contributions made by the decedent. Because these contributions were not taxable when contributed, they will be taxable when distributed, along with any applicable earnings. If the funds would not have been taxable to the decedent, then the funds will not be taxable to the beneficiary. An example would be any nondeductible contributions made by the decedent. Because these contributions were made with after-tax dollars, any distribution of these dollars will not be taxed. The beneficiary assumes the decedent's basis, which is not taxable. However, the earnings related to nondeductible contributions will be taxable to the beneficiary (as they would have been to the accountholder).

Question: In the above beneficiary situation, if the account totaled $20,000, would distributions of $3,000 for years 2002 - 2006, and $5,000 in 2007 be acceptable?

Answer: Yes, that would be an acceptable distribution schedule, because all amounts would be distributed by 12/31/2007, as required under the 5-year rule, as discussed above.