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ALSO IN THIS ISSUE –

Collin W. Fritz and Associates, Inc.,
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ACCEPTING & SEEKING 401(K) DEPOSITS

Because many individuals who have their 401(k) and other pension funds invested in mutual funds in the stock market have, in recent years, seen unprecedented losses (even substantial losses of principal), they are now seeking a secure investment and are contemplating moving their money into bank time deposits. Even though financial institutions are paying extremely low interest, these individuals realize that though they will be earning low interest, at least they will no longer be losing a portion of their retirement assets. By moving funds to a bank time deposit, the principal will be secure, and the individual will be gaining some earnings, even if the rate of interest paid is low. The security of a bank time deposit is worth more in our present-day uncertain economy than the potential of higher earnings rates in the stock market. Sort of "a bird in the hand" philosophy.

What many individuals don't realize is that if they have not attained age 59 1/2 or have not separated from the service of their employer, they cannot roll over 401(k) funds into an IRA. However, if the pension plan allows a plan participant to self direct their account, an individual can request a "change of investment" and have the funds put in a bank CD rather than their current mutual funds.

Bank time deposits are permissible investments for 401(k) funds, and banks could gain these deposits by aggressively marketing the fact that they are willing to be a depository for these funds. In most instances, a bank will choose to be a depository only, thus eliminating various plan administrative duties and limiting the bank's liability.

Your financial institution will have people who are currently customers with checking and savings/time deposit accounts who are also participants in a qualified plan at work. Many of these people will want a portion of their qualified plan account balance invested in a fixed-interest-rate instrument or a variable-interest-rate instrument which is entitled to insurance from the FDIC or similar insurance. Your financial institution should at least be aware that this is a deposit category for which there may be more demand than there has been in the past. If your financial institution has not already done so, you should establish the necessary procedures to seek out such deposits and to service them well.

Here is a typical situation. Mary Martinez comes to your financial institution. She is employed by ABC National Corporation as a senior computer programmer. She is an excellent customer of your institution. She currently has $80,000 of non-IRA/pension time deposits with your financial institution. She now comes to your financial institution and states that her employer maintains a 401(k) plan which allows her to direct the plan trustee how to invest her plan account balance. She tells you that she would like to have some of her 401(k) elective deferrals ($400 per month) invested in one or more time deposits as offered by your institution. She asks you if your institution will be able to accommodate her and the plan trustee. If you are willing, then she wants you to tell her what she and the plan trustee need to do to commence such deposits. She asks what "terms" will apply to her deposits.

Many institutions would probably tell Mary Martinez one of two things. First, she would be told, "We don't handle QP plans or deposits; we quit doing that years ago." Many institutions terminated their sponsorship of Keoghs (one-person qualified plans) during the period of 1986-1995. They apparently did so because they concluded that there were not sufficient business reasons (low profits, perceived higher liability exposure, or not necessary for customer retention) to seek and service such deposits. Many thought that the rules were too complex.

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Secondly, the institution's personnel might tell Mary that pension deposits may only be made in the trust department.

We would suggest that if a financial institution establishes and follows the proper administrative procedures, then most financial institutions (including the non-trust/retail side) should be willing and able to accept a pension deposit.

We would also suggest that financial institutions consider the following options in establishing its procedures with respect to pension deposits. The options are:

1. The institution decides to never accept any qualified plan deposits;
2. The institution decides to accept qualified plan deposits, but it makes very clear its policy that it will render no other services.
3. In order to encourage the making of qualified plan deposits, the institution decides to sponsor one or more qualified plan prototypes, but it also decides to require the business customer to consult with his or her own attorney, accountant, or pension consultant for all of the administrative requirements.
4. In order to encourage the making of qualified plan deposits, the institution decides to sponsor one or more qualified plan prototypes and decides that it will assist the business customer with some of the administrative tasks, but the employer will retain primary responsibility. For example, the institution will prepare Form 1099-Rs as based upon information furnished by the employer, plus the institution will assist with the preparation of the Form 5500 or 5500-EZ. The financial institution could either do the administrative service itself, or contract with a pension consulting firm to have such services performed.

Obviously, the administrative procedures which a financial institution adopts will vary depending upon which option it elects.

Purpose of This Article

The purpose of this article is to discuss option #2 — the institution will accept qualified plan deposits, but will render no other services. A financial institution may certainly accept deposits from the trustee of a qualified plan without rendering any plan document or administrative services. What should be the procedures for handling deposits and contributions when this option has been selected?

The Policy Considerations and Procedures With Respect to Accepting Deposits

Topic # 1. Understand Who Your Depositor or Customer Is

Your customer is the trustee of the qualified plan. The only person authorized to sign on this account will be the trustee. This is true even if the deposit is made on behalf of a specific person. The financial institution should never deal with the named plan participant, but should only deal with the trustee. When the trustee withdraws the funds, he or she will be doing so in their status as a trustee. Thus, the financial institution has no responsibility to prepare a Form 1099-R, and the withholding rules do not apply.

For example, Jane Doe, trustee of the ABC Corporation 401(k) profit sharing plan, purchases a time deposit in the amount of $25,000 for the benefit of John Smith, a plan participant. The owner of the time deposit is Jane Doe as trustee of the ABC Corporation Profit Sharing Plan and Trust. The tax identification number used with respect to the time deposit should be the TIN of the trust related to the plan. Your financial institution should never deal directly with the participant, John Smith. This is true even if the trustee would want you to make a distribution directly to John Smith. Based upon your service agreement (see discussion immediately below), you would inform Jane Doe, trustee, that such an action is administrative and is not your task, and that you will not pay the funds directly to John Smith, but that you will issue the check to her as trustee.

This same situation can occur with a one-person Keogh plan. Many financial institution personnel are confused in this situation. For example, Tom Mills has signed a profit sharing prototype document with First Investment Corporation which allows him, as the employer/plan sponsor, to invest his QP funds in numerous financial institutions. He now comes to your financial institution, First State Bank. Your institution does not sponsor a QP prototype. He wishes to purchase an $80,000 time deposit from you because you have excellent terms on a five-year CD. Note that he buys the time deposit in his status as the plan trustee. Again, when he comes in to withdraw the funds, you will deal with him in his status as being a trustee and not a participant. If you issue the check to him as trustee, then you will have no responsibility to prepare any Form 1099-R or to comply with the withholding rules.

Topic #2. Formalize and Establish Your Relationship With the Depositor/Trustee

We recommend that your financial institution and your customer (the trustee) sign a contract or service agreement wherein the depositor, as the trustee, formally acknowledges that he or she is making this deposit in their capacity as a trustee and not as a participant, and that the financial institution has no plan document or administrative duties. This will not generally be a problem when the trustee is acting on behalf of a plan with multiple participants. If a problem arises, it normally arises with respect to the one-person plans. Many times the doctors, dentists, etc. who establish these plans don't understand that there is a very important and critical difference in their respective roles of trustee or participant. The purpose of the service agreement is to emphasize that your financial institution is dealing with them because they are the trustee. Thus, when the person withdraws his or her deposit, you make

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the payee on the check, "Tom Mills as trustee of the Tom Mills profit sharing plan."

Topic #3. Decide What Type of Time Deposit, Savings Accounts and Checking Accounts You Are Going to Offer Your Pension Depositors

What type of time deposit will you offer Mary Martinez and the plan's trustee since the plan will be depositing $400 every month on her behalf? Do you want to sell the trustee 12 different CDs? Will you only offer a variable interest rate time deposit? Or, would your financial institution be willing to give a fixed rate?

Financial institutions may need to be more creative than they have been with this special type of deposit. As long as the plan trustee, on behalf of Mary Martinez, contractually promises that the subsequent monthly contributions over the term of the deposit account will be made, and that there would be defined penalties if they were not made, then it seems reasonable that a fixed rate could be offered.

Topic #4. Furnish the Required Pass-Through Insurance Notices As Required by FDIC Rules

A financial institution which is subject to FDIC regulation is required, in various situations, to furnish one of the various pass-through notices. A financial institution will need to furnish a notice in the following three situations:
(1) when an account is first opened;
(2) when a depositor requests one; and
(3) when the capital status of the financial institution deteriorates so that current deposits would not be entitled to pass-through coverage.

Topic #5. Data Processing and Governmental Reporting Considerations

This is where many financial institutions experience problems, because most data processing systems are written to handle only two types of deposits: (1) a non-IRA deposit which requires, in most cases, the generation of a Form 1099-INT or (2) an IRA deposit which requires the generation of Form 5498. The problem is that a qualified plan deposit is a unique third type of deposit. The income or interest earned by a qualified plan deposit is not subject to current income taxation under the Internal Revenue Code. In that sense, a qualified plan is very similar to an IRA. The difference is that a financial institution must report IRA contributions to the IRS on the Form 5498, but there is no similar form used to report the qualified plan contributions made by the sponsor of a qualified plan. Thus, the financial institution must be able to "shutoff" or not generate a Form 5498 for any QP/Keogh deposits.

On the other hand, a financial institution should not generate a Form 1099-INT to report any interest earned, since the pension trust does not currently pay taxes on its income. If the trustee can substantiate for your financial institution that he or she is acting on behalf of a qualified plan by furnishing you with a copy of the favorable IRS opinion or determination letter, then you should not generate a Form 1099-INT.

The employer who sponsors a plan covering many participants will report the aggregate total of its contributions on the IRS Form 5500. This employer, in most situations, will claim as a tax deduction, the amount of its contribution on its tax form.

The sponsor of a one-person plan will claim the amount of his or her contribution on Form 1040 and will also report it on Form 5500-EZ, if required to file such a form because the $100,000 threshold amount is exceeded.

Topic #6. Be aware that the Truth-In-Savings Rules Do Not Apply to QP Deposits

The Truth-In-Savings rules apply only to consumers, and deposits made by businesses (even one-person businesses) are not covered by TISA.

Policy Considerations and Procedures When the Deposit Is Withdrawn

This subject has already been briefly discussed. Again, your institution must only deal with the plan trustee. If your financial institution is dealing with a one-person plan, you must make sure you deal with this one person in his or her capacity as a trustee and not as a participant.

A standard qualified plan distribution form must not be used, as this payment of funds is not a distribution. The trustee has simply decided that he or she wishes to change how the funds are invested. A special withdrawal form should be used — a request for a withdrawal by a plan trustee. Your financial institution must issue the check to the trustee, and not to any participant. By issuing the check to the trustee, this means that there has been no distribution of assets (at least not yet) from the plan, and therefore, the withholding rules do not apply, and there is no need to prepare a Form 1099-R. If there is to be a distribution to a participant, then the trustee will have the duty to comply with all of the distribution rules — furnish the section 402(f) notice, furnish the withholding notice, and comply with the withholding rules and prepare the Form 1099-R to report the amounts distributed and withheld, if any.

Summary

With proper procedures, a financial institution should feel very comfortable accepting qualified plan deposits even though it does not sponsor any qualified plan prototypes or perform any administrative services.

THE REBIRTH OF ONE-PERSON QUALIFIED PLANS

There are two reasons why there will be a rebirth of one-person qualified plans. The first reason is that the person will be eligible to receive a loan from his or her plan. This right does not exist under a SEP or SIMPLE-IRA plan. Prior to 2002, owner-employees (which includes self-employed individuals) were not eligible to take advantage of the laws which allow a qualified plan to loan money to plan participants. Beginning January 1, 2002, a self-employed individual is able to borrow from his/her qualified plan just as a corporate employee many times is able. Of course, the standard loan rules must be met.

The second reason is that the person will benefit by establishing a 401(k) plan rather than a standard profit sharing plan.

401(k) Plans Now Available for Single-Participant Plans

Prior to EGTRRA, there was really no need for a single-participant plan to establish a 401(k) plan, as the maximum tax benefits for such a person could be realized with a profit sharing or SEP plan. And even now, if a person would always have net profits of $208,050 or more, the 401(k) plan would not be needed, because a profit sharing plan would also allow the maximum contribution of $40,000. A profit sharing plan is easier to administer than a 401(k) plan.

Under EGTRRA, for 2002, a single-participant business owner can contribute elective deferrals of $11,000 (if under age 50), and $12,000 (if age 50 or older), plus a 25% profit sharing contribution. For 2003, the amounts are $12,000 (if under age 50), and $13,000 (if age 50 or older), plus a 25% profit sharing contribution, to a maximum of $40,000 (if under age 50), or $41,000 (if age 50 or older).

The chart below illustrates that a person, in certain situations, will be able to have a combined contribution (elective deferral plus the standard profit sharing contribution) of much more than 25% of his or her compensation. This chart illustrates that generally much larger contributions are permitted by the 401(k) plan versus the SEP, SIMPLE or profit sharing plans.

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MAXIMUM CONTRIBUTION COMPARISON

Sole Proprietor Net Profits	Net Profits, Less 1/2 SE Tax	SIMPLE IRA	SEP/Profit Sharing/ Money Purchase	Single Participant 401(k)*	% of Net Profit, Less 1/2 SE Tax
$1,000	$929	$929	$186	$929	100%
$5,000	$4,647	$4,647	$929	$4,647	100%
$10,000	$9,294	$7,277	$1,859	$9,294	100%
$14,795	$13,750	$7,410	$2,750	$13,750	100%
$30,000	$27,881	$7,831	$5,576	$16,576	59%
$50,000	$46,468	$8,385	$9,294	$20,294	44%
$75,000	$69,701	$9,078	$13,940	$24,940	36%
$100,000	$93,367	$9,771	$18,679	$29,679	32%
$125,000	$118,062	$10,463	$23,612	$34,612	29%
$150,000	$142,728	$11,156	$28,546	$39,546	28%
$152,301	$144,998	$11,219	$29,000	$40,000	28%
$175,000	$467,393	$11,848	$33,479	$40,000	24%
$200,000	$192,058	$12,541	$38,412	$40,000	21%
$208,048	$200,000	$12,764	$40,000	$40,000	20%

*Maximum single-participant 401(k) contribution limits do not reflect the additional $1,000 "catch-up" contribution available to individuals age 50 or older.

$14,795 represents the last amount where 100% is contributed and deductible.

$152,301 represents where one first reaches the level of $40,000 combined.

$208,048 represents the amount of net profit necessary to accumulate $40,000 without needing a 401(k) deferral. Profit sharing contribution only.

Note: Elective deferral limits for 2003 will be $12,000 if under age 50, and $13,000 if age 50 or older.

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What Was the Law Prior to EGTRRA?

Prior to the advent of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), an employer with multiple employees offering a 401(k) plan was actually penalized for having a 401(k) plan versus having a regular profit sharing plan. For example, an employer with a regular profit sharing plan, with employee compensation of $400,000, would be allowed to contribute and deduct 15% of that amount, or $60,000 ($400,000 x .15). However, the same employer offering a 401(k) plan, whose employees had deferred $24,000, would only be allowed to contribute and deduct $32,400. Under the prior rules, the elective deferrals must be subtracted from the total compensation, leaving $376,000. This amount was then multiplied by the 15% allowable contribution to equal $56,400; then, the $24,000 again had to be subtracted, leaving only $32,400 as the employer's deductible amount.

However, under the new EGTRRA rules, an employer may now contribute and deduct 25% of income PLUS elective deferrals, plus catch-up contributions. In the above example, this would translate into a deductible amount of $124,000 (($100,000 x 25%) + $24,000); over twice the amount allowed under the regular profit sharing plan.

Other Law Changes Impacting One-Person 401(k) Plans

The compensation limit has been increased from $170,000 to $200,000.

The overall contribution limit has been changed from the lesser of 25% of compensation, or $35,000, to the lesser of 100% of compensation, or $40,000. The increase in the percentage limitation from 25% to 100% is an important increase for a self-employed individual.

No Discrimination Testing Involved

Because the plan is a one-person plan, it is deemed to pass all discrimination testing such as the ADP test. The purpose of this testing is to be certain that a plan does not favor highly compensated employees; obviously this is not a concern in a one-person plan.

Spouse as Employee

To take advantage of the special 401(k) rules for 2002, an employer generally will not have any other common-law employees who must be covered by the 401(k) plan. However, the business owner's spouse, if employed, is considered to be a business owner, and is not considered a common-law employee. Therefore the spouse is allowed to take advantage of the same elective deferral contribution amounts as listed above.

Example: The spouse (age 48) of a business owner earns $16,000 in 2002. She is eligible to contribute $11,000 plus the owner may contribute 25% of her earnings to the 401(k) plan, which equals $15,000 ($11,000 + (.25 x $16,000)).

Flexibility to Combine Retirement Assets

Under EGTRRA, most types of tax-qualified retirement plan assets can be rolled over or transferred to a single-participant 401(k) plan. This means that any IRA, SEP plan, or SIMPLE IRA assets, as well as any other qualified plan retirement assets, may be consolidated and rolled over or transferred to the new single-participant 401(k) plan. In fact, the 401(k) plan could be used to receive the taxable portion of an IRA, and the remaining nontaxable portion could be taken at a later time as a distribution, or converted to a Roth IRA. No tax consequences would ensue because the funds involved were after-tax dollars.

Governmental Reporting

Until a one-person plan accumulates assets greater than $100,000, no 5500 preparation is necessary. After reaching $100,000, a one-person plan need only prepare a 5500-EZ, which is much easier to complete than the more complicated Form 5500. There is also some discussion about raising the $100,000 limit to $250,000. This would greatly simplify reporting tasks for one-person plans.

How to Adopt a 401(k) Plan

The employer, even the one-person employer, must adopt a prototype plan or an individually designed plan. CWF's 401(k) prototypes may be used by a one-person business as well as a multiple-person business. For those financial institutions which have one or more of CWF's prototypes, we will sell you the 401(k) prototype for a fee of $100 plus the IRS filing fee of $120. You then will be able to make the 401(k) prototype available to your customers. You may well want to contact your customers using the profit sharing plan and see if they wish to switch to the 401(k) plan. For those financial institutions which presently do not have one of CWF's prototypes, the fee to purchase one would be $375 and the fee to purchase two would be $475.

IRS REVISES HOW TO CALCULATE THE EARNINGS FOR CERTAIN IRA CONTRIBUTIONS

The IRA tax laws have always been written to allow an IRA accountholder to un-do certain contributions. In order to receive this favorable tax treatment, many times it is required that the related or allocated income must be withdrawn, in addition to the withdrawal of the contribution. There are basically three types of contributions which can be un-done: (1) an impermissible contribution (i.e. an excess contribution); (2) a permissible contribution for the current tax year which the account-holder decides, for whatever reason, he or she no longer

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wishes to make; and (3) a permissible contribution for the current tax year which the accountholder decides to recharacterize to be a contribution for the "other" type of IRA.

The concept of being required to withdraw the related income has existed since the original creation of traditional IRAs. This rule was originally set forth (and is now set forth) in Code section 408(d)(4). The IRS, on August 7, 1980, adopted regulation 1.408-4(c)(2)(ii) which defined the method to be used to calculate the net income allocable to a contribution. This regulation defined the computation period as starting on the first day of the taxable year in which the contribution is made and ending on the date of the distribution. The allocable income will many times be overstated because of this requirement that the computation period starts on January 1. In addition, the allocable income could not be a negative number under this method.

In 2002, the IRS formally acknowledged that the method set forth in regulation 1.408-4(c)(2)(ii) should not be the only method allowed to calculate the related or allocable income. The IRS issued notice 2000-39 in July of 2000. This notice provided a new method for calculating net income that generally bases the calculation of the amount of net income attributable to a contribution on the actual earnings and losses of the IRA during the time it held the contribution. Under this new method, the related income may be a negative number. A last-in-first-out rule was to be applied if an IRA accountholder makes multiple contributions to the same IRA. Under notice 2000-39, it was required that there be a separate calculation of net income for each and every contribution. This notice had provided that, until further guidance was issued, either the old method under the regulation or the new method of this notice could be used. This notice asked people to submit their comments.

The comments were generally favorable, but some commentators did suggest some changes which the IRS has now adopted in issuing a proposed 2002 regulation. There were three fundamental changes suggested. Two were adopted and one was not. The first change is that a single computation period is used for nonrecharacterization contributions, even though there are multiple contributions. The second change is that the IRS clarifies how transfers in and out of IRAs are treated. These first two changes were incorporated into the proposed regulation.

The third suggested change was that the net income should be able to be determined on the basis of tracing specific assets rather than dollar amounts. The IRS did not adopt this suggestion. The stated reason was, "In the absence of maintaining separate accounts, tying particular assets to a particular contribution would create administrative problems for taxpayers, IRA providers and the IRS." This is not a convincing argument. In many cases, taxpayers have to maintain fairly detailed records, and the recharacterization situations are no different.

This proposed regulation, if adopted, will apply for calculating income allocable to traditional IRA and Roth IRA contributions made on or after January 1, 2004. With respect to contributions made during 2002 and 2003, IRA accountholder's will be able to use either the method set forth in notice 2000-39, or these 2002 regulations. If, and to the extent, future rules would be less favorable, the future rules would not be applied retroactively. Special note: As proposed, an IRA accountholder will no longer be able to use the original or old method that has been set forth in regulation section 1.408-4(c)(2)(ii).). The IRS will be accepting comments, if submitted on or before October 21, 2002.

The following special rules set forth in Notice 2000-39 were not changed. First, if the IRA accountholder has multiple IRAs, then the related earnings calculation is made only with respect to the IRA containing the IRA contribution that is distributed as a returned contribution to the IRA accountholder. The actual withdrawal must come from this IRA. The second special rule deals with determining the fair market value of an IRA asset not normally valued on a daily basis. When an IRA asset is not normally valued on a daily basis, the fair market value of the asset at the beginning of the computation period is deemed to be the most recent, regularly determined, fair market value of the asset, determined as of a date that coincides with or precedes the first day of the computation period. The third special rule is that net income calculations will be based on the overall value of an IRA and the dollar amounts contributed, distributed or recharacterized to or from the IRA, and not on the basis of the return of specific assets. As will be illustrated later, to do otherwise would allow IRA accountholders to recharacterize those Roth Conversion investments which only lose money, and this could cause too large a Revenue loss to the U.S. Treasury.

The New Method For Nonrecharacterized Contributions

The related or allocable income for a nonrecharacterized contribution is the pro rata portion of the earnings accrued by an IRA during the period the IRA held the contribution. The term of computation period means the period immediately prior to that time that the contribution being returned was made to the IRA and ending immediately prior to the removal of the contribution. If more than one contribution was made as a regular contribution and it is being returned from the IRA, the computation period begins immediately prior to the time the first contribution being returned was contributed. A regular contribution is an IRA contribution made by the IRA owner that is neither a trustee-to-trustee transfer from another IRA nor a rollover from another IRA or pension plan. The related or allocable income may now be a negative number. The formula to be used is:

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Net Income (Loss) Attributable to Portion Withdrawn =

$$\text{The contribution to be returned} \times \frac{\text{(adjusted closing bal. - adjusted opening bal.)}}{\text{adjusted opening balance}}$$

The adjusted opening balance is the fair market value of the IRA at the beginning of the computation period (i.e. immediately prior to the time the particular[ar contribution is made) plus the amount of any contributions (including transfer-in contributions and a contribution which is distributed and returned as a current-year contribution or a contribution which is recharacterized) during the computation period.

The adjusted closing balance is the fair market value of the IRA at the end of the computation period (i.e. immediately prior to the withdrawal of a particular contribution) plus the amount of any distribution (including a transfer-out distribution or a recharacterization distribution) during the computation period.

If there has been more than one "regular" contribution made to the IRA, then a single computation period is used to determine their related or allocable earnings. In addition, the regulation provides a last-in-first-out rule. Once the IRA accountholder identifies the dollar amount to be withdrawn, then the last contributions, to the extent necessary, will be deemed to have been withdrawn.

The IRS regulation contains two examples illustrating the new "earnings" method for Nonrecharacterized contributions. However, we have changed the years from 2004 to 2002 and/or 2003, because it is permissible to use the new rules for 2002 and 2003 calculations.

Example #1. Taxpayer "A" contributes $1,600 to her IRA on 5-1-02. Prior to her contribution, the fair market value of her IRA was $4,800. On 2-1-2003, she decides to withdraw $400 plus the related or allocable income. The fair market value of the IRA on 2-1-2003, is $7,600. There were no other contributions or distributions, including any transfers. The earnings formula will appear as follows:

Net Income (Loss) =

$$\$400 \times \frac{(\$7{,}600 - \$6{,}400)}{\$6{,}400} = \$400 \times .1875 = \$75$$

The total amount to be withdrawn is $475 = $400 plus $75 of related earnings

Example #2. Taxpayer "B" contributes $300 to her IRA on the 15th of each month in 2002 and 2003, Taxpayer "B" is age 45 in 2002. Because her contribution limit is $3,000 and she has contributed $3,600, she has an excess contribution of $600. On March 1, 2003, when the IRA has a fair market value of $16,000, she asks to be distributed the $600 plus the related or allocable income. The contributions to be returned to her are those made on November 15, 2002, and December 15, 2002. The fair market value of the IRA must be determined as of November 15, 2002, because that is the start of the computation period. On November 15 the IRA was worth $11,000 immediately prior to the contribution. Therefore, the computation period is November 15, 2002, to March 1, 2003. The earnings formula will appear as follows:

Net income (loss) =

$$\$600 \times \frac{(\$16{,}000 - \$12{,}200)}{\$12{,}200} = \$600 \times .3115 = \$186.89$$

The total amount to be withdrawn is $786.89 = $600 plus $186.89 of related earnings.

The adjusted opening balance is determined to be $12,200: $11,000 + $300 + $300 +$300 +$300. Note that four contributions made from November 15, 2002, to February 15, 2002, are added to the starting balance of $11,000 to arrive at an adjusted balance of $12,200.

The New Method for Recharacterized Contributions

The rules for determining the related or allocable earnings or losses for recharacterized contributions are very similar to those which apply to nonrecharacterized contributions, but there are some differences. There are different rules if more than one contribution is being recharacterized.

The computation period for a recharacterized contribution means the period immediately prior to that time that the contribution being recharacterized was made to the IRA and ending immediately prior to the recharacterization.

There will need to be a separate computation period for each recharacterization unless there was a series of regular contributions made to the IRA, and consecutive contributions in that series are being recharacterized. In this case, the computation period is determined using a single computation period, based on the first contribution in the series to be recharacterized. Note: there will need to be an earnings calculation for each conversion contribution to a Roth IRA which is subsequently recharacterized.

The IRA owner has the right to choose by date and dollar amount (and not by specific asset) which contribution is to be recharacterized. The related or allocable income for a recharacterized contribution is the pro rata portion of the earnings accrued by an IRA during the period the IRA held the contribution. The related or allocable income may now be a negative number. The formula to be used it is:

Net Income =

$$\text{The recharacterized contribution} \times \frac{\text{(adjusted closing bal. - adjusted opening bal.)}}{\text{adjusted opening balance}}$$

The adjusted opening balance is the fair market value of the IRA at the beginning of the computation period (i.e. immediately prior to the time the particular contribution is made) plus the amount of any contributions (including transfer-in contributions and a contribution which is

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distributed and returned as a current-year contribution or a contribution which is recharacterized) during the computation period. This includes the contribution being recharacterized plus all other recharacterized contributions made during the computation period.

The adjusted closing balance is the fair market value of the IRA at the end of the computation period (i.e. immediately prior to the withdrawal of a particular contribution) plus the amount of any distribution (including a transfer-out distribution or a recharacterization distribution) during the computation period.

Example #3. On March 1, 2002, Taxpayer "C" converts $160,000 to her Roth IRA from her traditional IRA. The fair market value of her Roth IRA on March 1, 2002, is $80,000. In preparing her 2002 federal income tax return, she determines she was ineligible to do the conversion. Therefore, on March 1, 2003, she requests to be distributed the $160,000 plus the related or allocable earnings. The fair market value of her Roth IRA on March 1, 2003, is $225,000. No other contributions, including transfers, have been made to the Roth IRA and no distributions have been made. The earnings formula will be:

Net income (loss) =

$$\$160{,}000 \times \frac{(\$225{,}000 - \$240{,}000)}{\$240{,}000} = \$160{,}000 \times (.0625) = (\$10{,}000)$$

The total amount to be withdrawn and transferred to her traditional IRA is $150,000 = $160,000 plus ($10,000).

Example #4. On April 1, 2002, Taxpayer "D" converts $100,000 to her Roth IRA from her traditional IRA. This is accomplished when she transfers 100 shares of Corporation #1's stock and 100 shares of Corporation #2's stock to her Roth IRA from her traditional IRA. On April 1, 2002, the fair market value of each set of 100 shares is $50,000. On November 1, 2002, the fair market value of Corporation #1's stock is $40,000 and the value of Corporation #2's stock is $70,000. No other contributions have been made to the Roth IRA and no distributions have been made.

Taxpayer "D" would like to recharacterize the shares of Corporation #1 back to her traditional IRA from her Roth IRA. However, the rules do not allow her to select the specific assets to be recharacterized. She may choose only by dollar amount that contribution or portion thereof that is to be recharacterized.

If she wants to recharacterize $50,000, then the formula to be used to determine the related or allocable income will be:

Net income =

$$\$50{,}000 \times \frac{(\$40{,}000 + \$70{,}000) - (\$50{,}000 + \$50{,}000)}{\$100{,}000} = \$50{,}000 \times .10 = \$5{,}000$$

The total amount to be withdrawn and transferred to her traditional IRA is $55,000 = $50,000 plus $5,000.

Observation #1. Even though the stock of Corporation #1 has decreased in value by $10,000, the stock of Corporation #2 has increased in value by $20,000, and it is the net value of $10,000 (the net of $20,000 gain with the loss of $10,000) which must be allocated to the assets which are moved back to the traditional IRA.

Observation #2. Once the net gain or loss is determined, the accountholder has sole discretion as to what specific assets are returned to the traditional IRA. Presumably, you would want to leave those assets you expect to perform best in the Roth IRA.

Example #5. Same example as #4 except she wants to recharacterize $40,000 rather than $50,000.

The formula to be used to determine the related or allocable income will be:

Net income =

$$\$40{,}000 \times \frac{(\$40{,}000 + \$70{,}000) - \$(50{,}000 + \$50{,}000)}{\$100{,}000} = \$40{,}000 \times .10 = \$4{,}000$$

The total amount to be withdrawn and transferred to her traditional IRA is $54,000 = $50,000 plus $4,000.

Conclusion. The IRS has proposed some relatively minor revisions to the proposals they made in 2000 for calculating the related or allocated income for excess contributions, current-year contributions and recharacterized contributions. The changes were very minor. The new method may be used immediately or the methods set forth in Notice 2000-39 may continue to be used. We expect that most IRA custodians will elect to use the new method when an IRA accountholder has made multiple regular IRA contributions and then elects to withdraw them plus the related earnings. The reason is—the IRA custodian will be able to make just one calculation (and not a separate calculation for each contribution) because the regulation authorizes the use of a single computation period. CWF will update the forms to be used to calculate the related or allocated income. CWF will have one form for contributions which are not recharacterizations and one for recharacterizations.

Clarification

A statement made in CWF's August newsletter entitled "Offering Simplified Employee Pension (SEP) Plan Services" (page 7) needs some clarification. It was stated in this article that "there is no age 70 1/2 requirement" with SEP plans. We need to clarify that even though contributions are still allowed to be made to a SEP for participants who are age 70 1/2 or older and have qualifying compensation or earnings, there is still the requirement that the participant must begin distributions from the plan in the year he/she attains age 70 1/2. We apologize for any confusion this may have caused.