THE Pension Digest

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ALSO IN THIS ISSUE –

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

Status of Proposed IRA/Pension Law Changes

President Bush's proposals received a less than enthusiastic reception from Congress. Even so, there is a good chance that some of his proposals (e.g. 401(k) changes) will be enacted. Congress has said that it soon will be considering other proposals also. A pension bill sponsored by Rep. Rob Portman (R-OH) and Rep. Ben Cardin (D-MD) passed last year in the House, but was not adopted by the Senate. This bill has been resubmitted in the House. In addition, there are a number of proposals dealing with IRAs. There is a proposal to change the RMD age from 70 1/2 to 75. There is also a proposal to put into effect immediately the IRA contribution limits of $5,000 for those under age 50 and $6,000 for individuals age 50 and older. Congress is also considering changing the FDIC insurance limits for most accounts to $130,000 (from $100,000) and to $260,000 for IRA and certain pension deposits. H.R. 522 (Federal Deposit Insurance Reform Act of 2003) was recently passed on April 2, 2003, in the House by a vote of 411 to 11. It has now been sent to the Senate. The fate of this bill is still uncertain, because Alan Greenspan does not favor this change.

Major Reporting Changes for Coverdell ESA's for 2003

The IRS has decided to separate the reporting for traditional IRAs and Roth IRAs from Coverdell ESA's. It only made sense, as a Coverdell ESA was never really an IRA type. The IRS will be revising the 2003 Form 1099-R and the 2003 Form 5498 by removing those sections dealing with Coverdell ESA's. We expect the IRS will be issuing the revised forms shortly, but they have not yet done so. The IRS has recently issued the forms to be used with respect to reporting contributions and distributions for Coverdell ESA's.

The IRS has created a new form for the reporting of contributions to a Coverdell ESA. It is Form 5498-ESA (Coverdell ESA Contribution Information). The IRS has revised an existing form for the reporting of distributions from a Coverdell ESA. It is Form 1099-Q (Payments From Qualified Education Programs Under Sections 529 and 530).

CWF and other form providers and software providers will need to hop to it so that a custodian/trustee will be able to do the proper reporting for 2003. CWF is now working to modify our Coverdell ESA forms and IRS reporting software. We should be finished with our modifications by July 1, 2003, for the Coverdell ESA forms, and on or before September 1, 2003, for the IRS reporting software.

Reporting Contributions

As previously stated, the IRS has developed a new form to report contributions to a Coverdell ESA.

There are only two boxes in which dollar amounts are to be inserted. You will note that this form does not include a box where the balance as of December 31, 2003, is to be reported.

The deadline for furnishing this form to the beneficiary is April 30, 2004, and the deadline for furnishing it to the IRS is May 31, 2004.

The IRS instructions to the participant for boxes 1 and 2 are as follows:

Box 1. Shows Coverdell ESA contributions made in 2003 and through April 15, 2004, on your behalf. Do not deduct these amounts on your income tax return.

If the total contributions made to all your Coverdell ESAs for 2003 exceeded $2,000, you must withdraw the excess, plus earnings, by May 31, or you may owe a

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penalty. You must keep track of your Coverdell ESA basis (contributions and distribution).

Box 2. Shows any rollover, including a direct rollover, you made in 2003. Generally, any amount rolled over from one Coverdell ESA to another Coverdell ESA for the benefit of the named beneficiary or a member of the beneficiary's family who is under age 30 (except for a beneficiary with special needs) is not taxable.

☐ CORRECTED (if checked)

TRUSTEE'S or ISSUER'S name, street address, city, state, and ZIP code	1 Coverdell ESA contributions $ 2 Rollover contributions $	OMB No. 1545-1815 2003 Form 5498-ESA	Coverdell ESA Contribution Information
TRUSTEE'S or ISSUER'S Federal identification no. / BENEFICIARY'S social security number			Copy B For Beneficiary
BENEFICIARY'S name Street address (including apt. no.) City, state, and ZIP code			The information in boxes 1 and 2 is being furnished to the Internal Revenue Service.
Account number (optional)			

Form **5498-ESA** (keep for your records) Department of the Treasury - Internal Revenue Service

Reporting Distributions

The 2003 Form 1009-Q is set forth below.

The very surprising change is that the IRS is apparently going to require the CESA custodian/trustee to determine and report the earnings portion of a distribution, the basis portion of a distribution and the gross distribution amount. In the past (1998-2002), the custodian reported the gross distribution and then left the taxable amount blank. It was left to the recipient (or the tax preparer) to explain what portion of the distribution was taxable and what portion was not. Note that just because a custodian will be reporting the earnings portion of a distribution does not necessarily mean that the recipient will have to include such earnings in his or her taxable income. The general rule is unchanged that withdrawals from a Coverdell ESA are tax free as long as they are not more than the designated beneficiary's adjusted qualified expenses for the year.

CWF Comment. This is a very major change. We are not sure the IRS understands or appreciates the magnitude of this change. A financial institution has never previously had to separately account for basis and earnings for traditional IRAs, Roth IRAs and Coverdell ESA's. Most data processing systems have not been designed to report contributions as being basis or earnings and distributions as being basis or earnings. We would not be surprised if the IRS revises the rule so that the form is completed one way for distributions from a qualified tuition program and another way for distributions from a Coverdell ESA.

A custodian/trustee must file the 2003 Form 1099-Q for a distribution occurring from January 1, 2003, to December 31, 2003, from a Coverdell ESA, including a distribution made directly (trustee-to-trustee) from one Coverdell ESA to another Coverdell ESA or a section 529 qualified tuition program. The deadline to furnish this form to the recipient is February 2, 2004. The deadline to furnish this form to the IRS is March 1, 2004, if you file by paper and by March 31, 2004, if you file electronically.

Why will the CESA custodian/ trustee be required to calculate the earning, amount to be inserted in box 2?

The IRS has previously issued proposed regulations for section 529 (qualified tuition) programs. Prop. Treas. Reg section 1.529-2(f) requires a section 529 program to maintain records with respect to the designated beneficiary of each account showing the total investment in the account (i.e. basis) and earnings attributable thereto. After the passage of EGTRRA (June 2001), the IRS issued Notice 2001-81 which provided additional guidance regarding record-keeping and reporting tasks. It now appears the IRS has chosen to apply the rules written for qualified tuition programs to Coverdell ESA's. The IRS instructions for box 3 (Basis) state, "For determining basis of a Coverdell ESA, you may rely on Notice 2001-81." CWF is assuming that the applicable statements set forth in Notice 2001-81 will apply for Coverdell ESA purposes as well as for qualified tuition programs.

☐ CORRECTED (if checked)

PAYER'S/TRUSTEE'S name, street address, city, state, ZIP code, and telephone number	1 Gross distribution $ 2 Earnings $	OMB No. 1545-1760 2003 Form 1099-Q	Payments From Qualified Education Programs (Under Sections 529 and 530)
PAYER'S/TRUSTEE'S Federal identification no. / RECIPIENT'S social security number	3 Basis $	4 Trustee-to-trustee rollover ☐	Copy B For Recipient
RECIPIENT'S name Street address (including apt. no.) City, state, and ZIP code	5 Check one: Section 529 program— Private ☐ or State ☐ Coverdell ESA ☐	6 If this box is checked, the recipient is not the designated beneficiary ☐	This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
Account number (optional)			

Form **1099-Q** (keep for your records) Department of the Treasury - Internal Revenue Service

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How will the custodian/trustee calculate the earnings amount to be inserted in box 2?

Prior to Notice 2001-81, if there was one or more distributions from a qualified tuition plan, then the earnings and basis related to such distributions were determined as of the close of the calendar year. However, in Notice 2001-81 the IRS states that "it is expected that final regulations will provide that, effective for distributions made after December 31, 2002, programs will be required to determine the earnings portion of each distribution as of the date of distribution." Presently, the proposed regulation for section 529 provides the following formula – the earnings portion of any distribution is determined by applying an earnings ratio, generally the earnings allocable to an account as of the close of the year, divided by the total account balance as of the close of the year, determined by adding back the amount of all distributions made during the year. We at CWF believe the IRS will authorize the use of a formula very similar to the one used to calculate the earnings with respect to the withdrawal of an excess contribution. In fact, we are suggesting a CESA custodian/trustee use that formula until the IRS issues additional guidance.

With respect to the aggregation of multiple Coverdell ESAs, it appears there will be a rule similar to that which the IRS has said will be adopted in final regulations for 529 plans. This means a Coverdell ESA custodian/trustee will be required to aggregate all of the Coverdell ESAs for the same designated beneficiary. Under current law, the designated beneficiary has been required to aggregate all of his or her Coverdell ESAs no matter how many custodians or trustees. This rule is being revised so that a Coverdell ESA may calculate the earnings portion of a distribution.

What new duties will a Coverdell ESA custodian/trustee have when rollovers or transfers occur?

As has been discussed above, the Coverdell ESA custodian will be required to maintain records with respect to the designated beneficiary of each account showing the total investment in the account (i.e. basis) and earnings attributable thereto. When funds or assets are rolled out or transferred out, the remitting custodian/trustee will be required to furnish an account statement that shows the basis amount and the earnings amount comprising the amount being rolled over or transferred When funds or assets are being rolled in or transferred in, the receiving custodian/trustee must ask to be furnished an account statement showing the basis amount and the earnings amount with respect to the amount being rolled in or transferred in. It shall then adjust the existing basis and earnings accounts accordingly. Until the receiving custodian/trustee receives this statement as prepared by the preceding custodian/trustee, it must treat the entire amount of the contribution as earnings.

Box 4 of the 1099-Q is new (Trustee-to-Trustee rollover), and is to be checked if a distribution was made directly to another Coverdell ESA or a qualified tuition program. In a trustee-to-trustee transfer between qualified eduction programs, the distributing program must provide your institution with a statement reporting the earnings portion of the distribution within 30 days of the distribution, or by January 10, whichever is earlier. The financial institution is then responsible for properly computing the earnings/losses to report in Box 2, and the basis to report in Box 3. The IRS is now treating transfers as a reportable event, when, in the past, they were not. It also appears the IRS is lumping rollovers and transfers together in this box.

The IRS has written the following instructions for the recipient of the Form 5498-ESA

Box 1. Shows the gross distribution (including in-kind distributions) paid to you this year from a qualified tuition program (section 529) or a Coverdell ESA (section 530). This amount is the total of the amounts shown in box 2 and box 3. See Pub. 970, Tax Benefits for Education, for more information.

Box 2. Shows the earnings part of the gross distribution shown in box 1. This may be taxable to you.

Under a qualified tuition program, the amount in box 2 is taxable to you if there has been (a) more than one transfer within any 12-month period with respect to the same beneficiary (see box 4), or (b) a change in the designated beneficiary, and the new designated beneficiary is not a family member.

Under a Coverdell ESA, the amount in box 2 is taxable to you if there has been a change in the designated beneficiary, and the new designated beneficiary is not a family member or is over age 30 (except for beneficiaries with special needs).

Also, an additional 10% tax may apply to part or all of any taxable earnings from the Coverdell ESA or qualified program. See Form 5329, "Additional Taxes on Qualified Plans (including IRAs) and Other Tax-Favored Accounts," and your tax return instructions for information about how to report any income.

If a final (total) distribution is made from your account and you have not recovered your contributions, you may have a deductible loss. Claim any loss on the "Other expenses" line of Schedule A (Form 1040), Itemized Deductions.

Box 3. Shows your basis in the gross distribution reported in box 1.

Box 4. This box is checked if you transferred the amount in box 1 from one eduction program to another education program in a trustee-to-trustee transfer.

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Overview of Tax-Advantaged Savings Plans

Existing Retirement Plans				
Plan	**Eligibility**	**Maximum Annual Contribution**	**Interactions with Other Plans**	**Effects of Bush Proposal**
457	Public sector employees	The lesser of $12,000 or 100 percent of adjusted gross income ($14,000 for those 50 an up); contributions are tax-deferred and distributions are taxable.	The $12,000/ $14,000 limit applies to all 457 plans a worker has, combined.	Uncertain. No new contributions after 2004 but 457 accounts could remain in existence.
401(k)	Offered by many private-sector employers (and certain tax-exempt organizations since 1996)	The lesser of $12,000 or 100 percent of adjusted gross income ($14,000 for those 50 and up); contribution is deductible from income, and distibutions are taxable.	The $12,000/ $14,000 limit applies to all 403(b) and 401(k) plans a worker has, combined. Limits the tax-deductibility of a worker's IRA	Would become an ERSA as of 2004
403(b)	Employees of certain tax-exempt and public education organizations	The lesser of $12,000 or 100 percent of adjusted gross income ($14,000 for those 50 and up); contribution isdeductible from income, and distributions are taxable.	The $12,000/ $14,000 limit applies to all 403(b) and 401(k) plans a worker has, combined.	No new contributions after 2004, but 403(b) accounts could remain in existence.
Traditional IRA	All workers under age 70 1/2 by the end of the calendar year.	$3,000 for those under 50, $3,500 for those 50 and over; contribution is sometimes deductible from income, and distributions are taxable.	Maximum contribution is for all a person's IRAs combined. Deductions are limited for workers with an employer retirement plan.	No new contributions after 2004, but IRA accounts could remain in existence. Traditional IRAs could be converted to RSAs but earnings and deductible contributions would be taxed. Taxes on conversions before 2004 could be paid over four years.
Roth IRA	Full contribution is limited to singles with income up to $95,000, and to $150,000 for married couples filing jointly; contribution phases out gradually beyond that	Full contribution is $3,000 ($3,500 for 50 and over); contribution is made with after-tax money, and distributions are tax-free	Maximum contribution is for all a person's IRAs combined	Would become an RSA as of 2004

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Existing Non-Retirement Plans				
Plan	**Eligibility**	**Maximum Annual Contribution**	**Interactions with Other Plans**	**Effects of Bush Proposal**
Coverdell ESA (formerly Education Savings IRA)	Beneficiary must be under 18 (over 18 allowed for special-needs students); fund can be used for all levels of schooling	$2,000; parents' income must be less than $15,000	Plan holder may also have a 529 plan	Could be converted to an LSA before 2004. Could coexist with the proposed plans, including new contributions; Coverdell balance converted to an LSA would not be taxed and could be used for any purpose
Section 529 Plan	Anyone can establish an account for a designated beneficiary to use for qualified higher-education expenses	Varies by state	Plan holder may also have a Coverdell Plan	Could be converted to an LSA before 2004. Could coexist with the proposed plans; 529 balances converted to an LSA would not be taxed and could be used for any purpose
Medical Savings Account (MSA)	Self-employed, small-business owners and employees	Varies, around $3,800 for a family	Cannot have other health coverage	Could be converted to an LSA before 2004. Could coexist with the proposed plans; MSA balances converted to an LSA would be taxed and could then be used for any purpose

Major Reporting Changes, Continued from page 3

Box 5. Shows whether the gross distribution was from a qualified tuition (private or state) program or from a Coverdell ESA.

Box 6. This box is checked if you are not the designated beneficiary under the Section 529 program or an ESA.

Summary: The 1099-Q form is new for 2003 to report CESA distributions. Without additional guidance from the IRS, the financial institution will be responsible to calculate the taxable amount of a CESA distribution reported on this form. The IRS now considers a transfer to be a reportable event. CWF will keep you informed as to any changes to this form.

Forms 1099-R and 5498: The IRS has not yet issued the 1099-R and 5498 for traditional and Roth IRAs for the coming year.

RMD Correction

In a prior newsletter, we had made a statement that has since been proven to be erroneous.

Situation – A husband and wife each have an IRA. They are both already in distribution (i.e., they are both older than 70 1/2), and each is the other's sole beneficiary. The husband dies in August of 2002. For 2002, the husband will be treated as if he had lived the entire year, and his RMD will be paid to his wife as beneficiary. The wife will also receive the normal distribution from her own IRA.

Incorrect – We had erroneously stated that if a sole surviving spouse did not elect to treat the deceased spouse's IRA as their own by 1/1/03, she must use the factor from the Single Life Table to calculate the distribution amount from this inherited IRA for 2003 and all subsequent years.

Correction – A surviving spouse who is the sole beneficiary of their deceased spouse's IRA may elect to treat the IRA as their own at any time, and the required minimum distribution will be determined as if each surviving spouse were the owner beginning with the year they elect to treat the IRA as their own. Electing to treat the IRA as their own allows the surviving spouse to use the Uniform Lifetime Table instead of the Single Life Table, which will normally result in a decrease in the required distribution amount.

Example – If the surviving spouse in the above situation does not elect to treat the IRA as her own until August of 2006, she would have to use the factor from the Single Table to calculate distributions from the decedent's IRA for 2003, 2004, and 2005. However, because she had elected to treat the IRA as her own in 2006, she would be able to use the factor from the Uniform Lifetime Table to calculate the 2006 distribution from this IRA.

'Tis the Season for Withdrawing Excess Contributions

IRA accountholders are going to their tax preparers/advisors and are being told a number of things. First, they are being told that they made an excess contribution for 2002 and that they need to correct it by withdrawing such excess amount (and the related income). Secondly, they are being told that they made a contribution for 2002 which is not deductible and therefore they need to withdraw the contribution amount plus the related earnings.

CWF has prepared a special form, "Special Explanation Regarding the Withdrawal of a 2002 'Current-Year' Contribution." This form explains how the accountholder should handle this transaction on his or her tax return. This is not tax advice. The IRS, in the instructions for the Form 1099-R, asks the IRA custodian to furnish such a notice, since, in the situation of when the contribution was made in 2002 and withdrawn in 2003, the 2003 Form 1099-R with a reason code "P" will not be furnished to the accountholder until January of 2004. This distribution must be included on the 2002 tax return, since the law requires that the income be taxed in the year in which the contribution was made, and not the year for which the contribution was made. In this case, the income is actually earned in both 2002 and 2003, but it is taxed in 2002. If you don't use such a form, you should.

The tax laws provide a 6% excise tax on an excess contribution which has not been corrected. This is an annual tax. It is the responsibility of the individual. However, in some situations, the individual may try to argue that the IRA custodian should bear some part of the tax pain.

Illustration #1. Sally Toms is age 68. She has made IRA contributions of $2,000 for 1998-2001. She has made a contribution of $3,500 for 2002. She has just gone to a new accountant who has told that she never should have made these contributions, because she did not have any wages or earned income. She had signed IRA contribution forms indicating she was eligible to make the contributions. She has excess contributions and the 6% tax will be owing. The IRA custodian most likely, in this situation, will not have any liability.

Illustration #2. Carol Myers and David Myers are married. Carol has been making contributions to her traditional IRA for herself for the last 12 years. Contributions have also been made for David under the spousal contribution rules. Carol is age 69 and David is age 75. They have just gone to a new accountant who has told them that many of David's contributions are excess contributions, and the 6% tax will be owing. A cardinal IRA rule is that a person is not eligible to make a traditional IRA contribution for the year he or she attains age 70 1/2. The IRA custodian, in this situation, may have some liability, because it should have known his age and known that contributions to a traditional IRA for him were not permissible. He is eligible (and would have been) for Roth IRA contributions. Under present law, the only contributions which can be recharacterized are current-year contributions. Therefore, the only way to correct his situation is to withdraw the excess contributions.

There is different reporting when the excess contribution is being withdrawn after the due date of the tax return rather than before the due date. In this situation, there is no requirement to withdraw the related income. On page R-6 of the 2002 IRS Instructions for Forms 1099-5498, the IRS states for a distribution of contributions without earnings after the due date of the individual's return, under section 408(d)(5), enter 0 (zero), in box 2a (taxable amount) and the gross amount in box 1. Use Code 1 or 7 in box 7, depending on the age of the participant.

The rule — if an IRA accountholder/taxpayer can meet the following two requirements, then he or she will not be taxed (i.e. required to include the distribution in his or her income) on the withdrawal of an excess contribution after the due date. The two requirements:

1. No deduction has been allowed with respect to such excess contribution. However, the amount allowable as a deduction under section 219 (after application of section 408(o)(2)(B)(ii)) shall be increased by the nondeductible limit under section 408(o)(2).
2. The aggregate contributions for the year (excluding rollovers) do not exceed $2,000 (for 2001), or $3,000/$3,500 for 2002-2004.

Exception for SEPs: The $2,000, $3,000 or $3,500 limit is increased to the lesser of the amount of the SEP contribution, or the dollar limit in effect under 415(c)(1)(A).

Exception for excess rollover contributions attributable to erroneous information:

The contribution limit is increased to the extent of the erroneous information, and the taxpayer must reasonably rely on this information which was supplied pursuant to Subtitle F for determining the amount of a rollover contribution.

Example of Mr. John White: *He withdraws the $2,000 excess contribution made on 6-6-01, on 10-20-02 (after the 4-15-02, due date). Mr. White is 45. For 2001, he owes a 6% excise tax ($120) on the excess contribution. If he has not paid this tax, he should file forms 1040X and 5329 and remit payment to the IRS. For 2002, he will not be taxed on the distribution of the $2,000 as long as no deduction was allowed. The $2,000 is inserted in box 1 and "0" is inserted in box 2a. The reason code is "1" since he is 45. Also, there will be no 6% excise tax for 2002, since the excess has been eliminated (i.e. corrected). NOTE: He is not required to withdraw the related earnings.*

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Use of Reason Codes "8" and "P"

When is reason Code P used and when is reason Code 8 used on the 2002 Form 1099-R? Reason Code P is used when a customer makes a current-year contribution in one year (e.g. 2002), and withdraws it in the next year (e.g. 2003) but by the due date of their tax return, including extensions. The current tax year is still 2002, since it is prior to the due date of the tax return, including extensions. A current-year contribution may be an excess, but does not need to be. An excess contribution is an impermissible contribution, whatever the reason.

Any contribution made during the current year may be withdrawn as long as the three applicable rules are met (withdrawn by 4-15-XX, plus extensions, if any; no deduction was allowed; and the related income must be withdrawn).

A special rule in the Internal Revenue Code states that the income related to this current-year contribution will be taxed in the year in which the contribution was made (i.e. 2002), even though the distribution takes place in 2003.

This is an exception to the general rule that the customer is taxed in the year in which they receive an IRA distribution.

The IRA trustee/custodian must prepare a 2003 Form 1099-R and use a reason Code P. The "P" tells the IRS that the income is taxable for 2002, and should have been reported on the customer's tax return for 2002.

Since the income is taxable to the customer on his or her 2002 return, the IRS instructions strongly suggest to the financial institution that they tell the customer that the income is to be included on their 2002 return. This is the reason for our Form #67 (Special Explanation Regarding the Withdrawal of a Current-Year Contribution). There is also some special language on the CWF distribution form to explain this special rule.

In contrast, the reason Code 8 is used in two situations.

First, it is used when a person makes a current-year contribution during the carryback period (in 2003, for 2002) and withdraws it the same year (2003). In this situation, the IRA custodian should generate a 2003 1099-R and use Code 8.

Secondly, it is used when a person makes a current-year contribution during the regular period (e.g. in 2002, for 2002) and withdraws it in the same year (e.g. 2002). The IRA custodian would prepare a 2002 Form 1099-R.

Update on IRS SEP Filing

On March 10, 2003, CWF spoke with the IRS concerning our SEP filing. They informed us that our submission has been approved. They indicated that we should be receiving our opinion letters within the next few weeks. We will forward each institution's opinion letter upon receipt. We will then also enclose an order form so that you may order the SEP kits and other SEP forms which you will need to update your customers' SEP plans.

Special Explanation Regarding the Withdrawal of a 2002 "Current-Year" Contribution

Custodian/Trustee: ______________________________

Accountholder's Name: ______________________________

Social Security Number: ____________________ **IRA Account Number:** ____________________

This form explains to you, the Accountholder, the complex rules for the withdrawal of a "current-year" contribution. A current-year contribution is one for which the tax deadline (plus extensions) has not yet passed. Thus, a contribution made at any time in 2002, for 2002, or between January 1, 2002, and April 15, 2003, for 2002 (during the carryback period) is considered a current-year contribution for 2002.

If you satisfy the following three (3) requirements, you will not be taxed on the withdrawal of a 2002 current-year contribution from your IRA.

1) You must withdraw the contribution by April 15, 2003 (plus extensions);

2) No deduction must have been allowed for the contribution for the tax year in question; and

3) Any interest or other income earned by the contribution must also be withdrawn. The interest or other income earned on this contribution must be included in your gross income, and the 10% additional tax on a distribution prior to age 59½ must be paid, if applicable.

Accountholder's Instructions to Withdraw and Signature

✓ On ____________________ (specify date) I contributed $____________ to my IRA account for the 2002 tax year. On this date ____________________, I hereby instruct you (the custodian/trustee) to withdraw $______________ plus the related income of ____________.

Signature of Accountholder ______________________________ Date ____________________

Special Explanation by Custodian/Trustee—Because Action is Required by the Accountholder

✓ On ____________________ (specify date) we, as custodian/trustee of your IRA account, distributed to you, the accountholder, $______________ of which $____________ is the return of your contribution and $____________ is the related income (i.e. earnings/interest).

You must reflect on your Federal income tax return <u>all amounts</u> distributed to you. However, you will reflect two amounts on your Federal income tax return: the gross amount and the taxable amount. We expressly recommend that you consult with your tax advisor or preparer, or that you review IRS Publication 590. The following paragraphs discuss the Federal income tax consequences.

You have withdrawn a 2002 current-year contribution. You must reflect this distribution on the tax return for the year <u>in which you made</u> the contribution and <u>not the year in which it was withdrawn, or for the tax year for which the contribution was made</u>.

Example: John Davis contributes $2,000 on May 10, 2002, for tax year 2002. On April 2, 2003, John decides he no longer wishes to leave that contribution in the IRA because he may have been ineligible to make the contribution (i.e. an excess contribution) or he has discovered that some or all of the contribution does not qualify to be deducted. John, therefore, elects to withdraw all of this current-year contribution plus the related earnings. It is determined that $125.45 of earnings are attributable to the contribution amount to be withdrawn. John must report the gross distribution amount of $2,125.45 (on line 15a of the 2002 1040 return) and the taxable amount of $125.45 (on line 15b* of the 2002 return). The taxable amount is only $125.45 as long as the three rules discussed above have been met. If John is under age 59½ and no other exceptions apply, the 10% premature excise tax will apply. He will need to complete Form 5329 and line 53* of the 2002 Form 1040 and pay the additional 10%.*

<u>Special Note.</u> We, as custodian/trustee of your IRA, will report the removal of the 2002 current-year contribution and earnings for the year in which you take the distribution, even though you will include this in income in the year in which you made the current-year contribution. Thus, if you withdraw your 2002 contribution in 2002, you will receive a 2002 Form 1099-R as applicable. If, in 2003, you withdraw a 2002 contribution made in 2002, then you will receive a <u>2003</u> Form 1099-R on or before 1-31-04, which will indicate the income is taxable for the 2002 tax year. The reason code "P" will be inserted in box 7 of the Form 1099-R. Your 2003 withdrawal of a contribution in 2002 must be reflected on your 2002 tax return even though you will not receive the 1099-R until 2003. If you make a 2002 contribution in 2003, and then elect to withdraw it in 2003, the related income will be reported on a 2003 Form 1099-R and will be taxable to you for 2003.

*Because these line numbers are subject to change by the IRS, please check the 1040 Instructions to be certain that you are using the correct line.

IRA #67 (6/01)* White—Custodian/Trustee Yellow—Administrator

Withdrawing "Basis" from a Roth IRA – Selling the Roth IRA

More individuals would contribute funds to a Roth IRA if they would understand that, in general, the federal tax code does not require the individual to pay any type of tax for withdrawing their basis from a Roth IRA. Many individuals have the mistaken concept that there are harsh tax penalties if one withdraws funds from a Roth IRA before age 59 1/2, as happens if one withdraws funds from a traditional IRA. Most people are aware of the 10% tax additional tax applying to distributions from a traditional IRA before a person is age 59 1/2. In general, this 10% tax is not imposed on distributions from a Roth IRA because the 10% tax applies only to the extent the distribution is required to be included in income. The exception is – the 10% additional tax is imposed upon a person if he or she converts funds from a traditional IRA to a Roth IRA and then withdraws such funds before a five-year holding requirement has been met. Prior to the enactment of the exception into law, every taxpayer who was not yet age 59 1/2 could have avoided the 10% additional tax by converting his or her traditional IRA to a Roth IRA and then taking an immediate distribution.

What is "basis"? Any contribution to a Roth IRA constitutes "basis," since no taxes will be owing when the "basis" is distributed to the person, as he or she received no tax benefit for making the contribution (i.e. no tax deduction for the contribution).

There are two types – annual contributions and conversion contributions.

What is the order or source of distributions from a Roth IRA for taxation purposes? Annual contributions come out first. Once they are totally distributed, then conversion contributions come out second. The oldest conversion contributions come out first. Once all of the conversion contributions have been distributed, then the earnings of the account are distributed. The distribution of these earnings is not taxable (included in income) if it is a "qualified distribution." The distribution of these earnings is taxable if it does not qualify as "qualified distribution," and it will be subject to the 10% additional tax unless one of the exceptions (e.g. 59 1/2, disability, substantially equal periodic payment, eduction, etc.) would apply.

Example #1. Rita Pajak, age 29, contributed $2,000 to her Roth IRA for 2000 and 2001. She contributed $3,000 for 2002. She intends to contribute $3,000 for 2003. She established her Roth IRA with the intent of some day using it for some or all of her down payment on a house. The December 31 balance of her Roth IRA has been as follows:

December 31, 2000	$2,120
December 31, 2001	$4,300
December 31, 2002	$6,500

On April 24, 2003, Rita withdraws $900 to have her car repaired. What are her tax consequences if she withdraws $900 from her Roth IRA? She will need to report the distribution of $900 on her tax return, but she will not have to include the $900 in her taxable income, since she is being returned her basis of $900. The 10% tax never applies to the return of basis attributable to annual contributions. Obviously, this $900 will no longer be in the account with the chance to earn income never to be taxed.

Example #2. Ted Mims, age 45, contributed $2,000 to his Roth IRA for 1999, 2000, and 2001. He contributed $3,000 for 2002. He intends to contribute $3,000 for 2003. The December 31 balance of his Roth IRA has been as follows:

December 31, 1999	$2,120
December 31, 2000	$4,300
December 31, 2001	$6,500
December 31, 2002	$9,700

Ted decides he wishes to buy a new car. What are his tax consequences if he withdraws $2,400 from his Roth IRA to use as the initial payment? He will need to report the distribution of $2,400 on his tax return, but he will not have to include the $2,400 in his taxable income, since he is being returned basis of $2,400. The 10% tax never applies to the return of basis attributable to annual contributions.

Example #3. Patty Izatys, age 54, converted $24,000 from her traditional IRA funds to a Roth IRA in 1999. She has made annual contributions of $2,000 for 1999, 2000, and 2001. She made an annual contribution of $3,000 for 2002. She intends to contribute $3,000 for 2003. The December 31 balance of her Roth IRA has been as follows:

December 31, 1999	$27,500
December 31, 2000	$29,700
December 31, 2001	$32,100
December 31, 2002	$34,600

Patty has unexpected medical expenses of $4,400. What are her tax consequences if she withdraws $4,400 from her Roth IRA? She will need to report the distribution $4,400 on her tax return, but she will not have to include the $4,400 in her taxable income since she is being returned her basis of $4,400. She is not being returned any portion of the amount she converted, since conversion amounts are only distributed once all contributions have been distributed.

Summary. A person may wish to set up a Roth IRA as his or her primary savings account rather than a general savings account. As long as he or she will never withdraw the income as a nonqualified distribution, he or she will not have any adverse tax consequences. Early surrender charges would need to be considered.