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ALSO IN THIS ISSUE –

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

SEP UPDATING — USE PROTOTYPE OR IRS FORM 5305-SEP?

There seems to be confusion as to the differences in using CWF's prototype SEP plan versus the IRS Model Form 5305-SEP to update a financial institution's SEP customers as required by the IRS.

Why Amend?

The IRS has mandated that all SEP plans be amended if the adopting employers wish to use the new increased contribution limits. The limits have increased to the lesser of 25% of compensation, or $40,000. The former limits were the lesser of 15% of compensation, or $25,000. This is a substantial increase; your SEP employers will want to be made aware of this change and take advantage of it.

Why Use a Prototype –

You will have to review the SEP plans which your customers have had and determine if there is a reason for using the prototype. Your customer will want to use a prototype if:

1) Their business is run on a fiscal year basis (the 5305-SEP allows only a calendar-year basis);

2)They desire to have their plan integrated with social security (in which case the highly-compensated employees can receive a slightly larger contribution)

3) The employer has established any other pension plan(s). The 5305-SEP can only be used if it is the sole plan of the employer.

One other reason is that, for the bank's marketing purposes, a prototype plan may look more "professional" than the 5305-SEP. For example, CWF's SEP kit is provided in a profession-looking folder, and the adoption agreement and plan document are in booklet form (8 1/2" x 11").

If none of these reasons are a factor, then you will probably want to use the 5305-SEP to update your customers.

Updating Using a Prototype –

To update using a prototype, the customer will have to complete and sign a new adoption agreement. If you have CWF's prototype, we have SEP kits available for one-person and multiple-person SEP plans. In these kits, you will receive all the forms necessary to update your customer's SEP plan. You will need to provide them with the IRS opinion letter which was sent to you in April.

Updating Using IRS Form 5305-SEP –

Unless there is a specific reason to use a prototype (as discussed above), the IRS Form 5305-SEP is a perfectly valid means to update your SEP customers.

To amend using the IRS Form 5305-SEP (available from CWF in a 2-part carbonless form, or from the IRS web site), your customer merely has to complete and sign the form. They will then be eligible to use the new, increased contribution limits. The advantage to using the 5305-SEP is that it is very simple to complete, and no IRS filing/fees are involved, as with the prototype. A disadvantage is that, if you do not have CWF's prototype contract in force, we will not be notifying you as to when changes/updates are necessary to SEP plans, and you will lose access to CWF's Hotline Consulting on SEP matters unless you have purchased our total consulting through another contract/service.

Inactive SEPs – What Can Be Done?

Another question financial institutions face is what can/should be done with a SEP plan to which contributions haven't been made for years. To simplify administration for the bank and the SEP customer, we suggest contacting those who have not made SEP contributions in 4-5 years or longer and putting them on notice that you will be retitling their SEP-IRA to be a normal, traditional IRA. The letter should explain that the same IRA rules apply to a traditional IRA that applied to the SEP-IRA. You could also state in the letter that if they do not reply to the contrary within 30 days of the

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date of the letter, you will automatically retitle the SEP-IRA to be a traditional IRA.

Deadline to Amend —

Amending the SEP of your customers is not needed at all if they do not wish to take advantage of the larger contribution limits now allowed (the lesser of 25% of compensation, or $40,000).

The deadline to amend using the IRS Form 5305-SEP was to be 12/31/02, if an employer wished to use the new contribution limits for 2002. The IRS had set the 12/31/02 deadline, and then set yet another deadline of 4/15/03 plus extensions. This obviously is inconsistent, but CWF believes it would be permissible to use the 4/15/03 plus extensions, if your institution would have an employer who has not yet amended and who wishes to use the IRS Form 5305-SEP.

The deadline for using CWF's prototype to amend is 180 days after the date on your institution's IRS opinion letter. This date is April 7, 2003; therefore, institutions using CWF's prototype have until October 4, 2003, to have their customers sign revised CWF SEP Adoption Agreements.

WHAT TO DO—AN IRA CUSTOMER WANTS HELP CORRECTING AN EXCESS CONTRIBUTION?

You and other IRA custodians have just mailed out your 5498 forms. Some of your customers are realizing they made an excess contribution for 2002. They are now coming to you for help. The purpose of this article is to suggest a course of action and why. Our suggestion is not that you simply tell your customer that he or she must see their tax advisor, or that he or she must figure it out. You can render some assistance without it amounting to tax advice.

Example #1 –
Contribution Made in 2003 and Withdrawn in 2003

Mary Doe (age 55) made a traditional IRA contribution of $3,500 on 4-15-03 for 2002. The problem is—on February 4, 2003 she had made a contribution for 2002 to the same traditional IRA in the amount of $500. She forgot she had made this contribution. She knows she has an excess contribution of $500 because the 2002 Form 5498 shows she contributed $4,000. She is asking what she must do. She filed her income tax return on April 15, 2003. She is asking if she must amend her 2002 tax return and pay the 6% excess tax on the $500, or $30.

Suggested Approach to Resolve the Situation

You should suggest she talk with her tax advisor and review the 8606 form (nondeductible contributions) and related instructions. However, you, as the IRA custodian, will need to help her because you have the information needed to correct the situation. You should furnish her with a copy of CWF's Form #67, *Special Explanation for Withdrawing an Excess or Current-Year Contribution for 2002.* This form explains what needs to be done to qualify for certain special income tax treatment. The income earned by the $500 excess contribution must be withdrawn along with the $500. You may use CWF Form #67W to calculate the allocable income. You will want to furnish a copy of Form #67W also to the accountholder. Note that a last-in, first-out rule is used. This means the excess was made on April 15, 2003, rather than on February 4, 2003. It is assumed the earnings were $7. Five hundred and seven dollars ($507) will need to be returned to the accountholder. Your institution, as the IRA custodian, will prepare for her a 2003 Form 1099-R (in January of 2004), and the reason code "81" should be inserted in box 7. The "8" tells the IRS there was an excess contribution and that it is taxable in 2003, and the "1" tells the IRS she owes the 10% additional tax because she is younger than 59½.

On her 2003 federal income tax return she will show an IRA gross distribution of $507 and that the $7 of income is taxable. The rule is—the income is taxed in the year in which the contribution is made (2003) and not the year for which the contribution was made (2002).

She is NOT required to amend her 2002 federal income tax and pay the 6% excess contribution tax of $30 because she eliminated the excess by withdrawing it on or before October 15, 2003. A few years ago, the IRS changed the deadline for correcting excess contributions to October 15 of the following year rather than April 15 as modified by any extension. You may want to explain to her that the IRS may write her a letter indicating that she made an excess contribution and asking if she corrected it. In which case, she could furnish a written explanation that she withdrew the excess and attach CWF Forms #67 and #67W with her reply. This should resolve the matter.

Example #2 –
Contribution Made in 2002 and Withdrawn in 2003

Tom Doe (age 57) made a traditional IRA contribution of $3,000 on 12-15-02 for 2002. The problem is—on February 4, 2002 he also made a contribution for 2002 in the amount of $3,500 to an IRA at another financial institution. He had forgotten he had made this contribution. He knows he has an excess contribution of $3,500 because his two 2002 Form 5498s showing he contributed a total of $7,000. He is asking what he should do. He filed his income tax return on April 1, 2003. He is asking if he must amend his 2002 tax return and pay the 6% excess tax on the $3,500, or $195.

Suggested Approach to Resolve the Situation

You should suggest he talk with his tax adviser. However, you, as the IRA custodian, will need to help him because you have the information needed to correct the situation. You should furnish him with a copy of CWF's Form #67, *Special Explanation for Withdrawing an Excess or Current-Year Contribution for 2002.* This form explains what needs to be

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done to qualify for certain special income tax treatment. The income earned by the $3,500 excess contribution must be withdrawn along with the $3,500. You may use CWF Form #67W to calculate the allocable income. You will also want to furnish a copy of Form #67W to the accountholder. Note that a last-in, first-out rule is used. This means the excess was made on December 15, 2002 rather than February 4, 2002. It is assumed the earnings were $130. Three thousand six hundred thirty dollars ($3,630) will need to be returned to the accountholder. Your institution, as the IRA custodian, will prepare for him a 2003 Form 1099-R (in January of 2004), and the reason code "81" should be inserted in box 7. The "8" tells the IRS there was an excess contribution and that it is taxable in 2002, and the "1" tells the IRS he owes the 10% additional tax because he is younger than age 59½.

The rule is—the income is taxed in the year in which the contribution is made. Since the contribution was made in 2002, he is required to amend his already filed 2002 return. He will need to amend his return to show he received an IRA distribution (line 15) of $3,630, of which $3,500 is not taxable as it is the return of an excess contribution. The earnings of $130 must be shown as taxable income, and Form 5329 must be completed to show $13 is owing (i.e. the 10% additional tax). He will want to attach an explanation and the forms showing he has corrected the situation prior to October 15, 2003. Again, a few years ago the IRS changed the deadline for correcting excess contributions to October 15 of the following year rather than April 15 as modified by any extension. By filing the amended return and attaching an explanation, the matter should be resolved.

HOW MANY 5498s MUST AN INSTITUTION PREPARE FOR AN ACCOUNTHOLDER?

CWF received a consulting call with the following situation. A customer brought a Form 5498 to the institution and asked why all of his various accounts were combined onto one 5498. The institution's software vendor had prepared the 5498 in this manner. When the question was raised that this may not be correct, the software vendor wanted proof from the institution that combining all a customer's accounts on one 5498 is not correct.

In answer to this question, CWF provide the applicable section of the 5498 instructions for 2003 (the 2002 instructions contained identical language). It reads as follows:

Specific Instructions for Form 5498

File Form 5498, IRA Contribution Information, with the IRS by May 31, 2004, for each person for whom in 2003 you maintained any Individual retirement arrangement (IRA), including a deemed IRA under section 408(q).

An IRA includes all investments under one IRA plan. It is not necessary to file a Form 5498 for each investment under one plan. For example, if a participant has three certificates of deposit (CDs) under one IRA plan, only one Form 5498 is required for all contributions and the fair market values (FMVs) of the CDs under the plan. ***However, if an individual has established more than one IRA plan with the same trustee, a separate Form 5498 must be filed for each plan****"* (emphasis added).

Obviously a Roth IRA and traditional IRA have separate plan agreements, and therefore cannot be combined onto one 5498. Your institution will want to be certain your software provider is preparing all governmental reporting correctly. You need to be aware that IRS penalties can be assessed for incorrect reporting. The penalty is $50 per incorrect 5498.

We at CWF find it interesting that when this situation was brought to the software vendor's attention, they required the financial institution to prove them wrong! We do not think it is unreasonable to expect the software vendor to perform its own research to determine the correctness of the reports they are providing to financial institutions, once a question has been raised regarding the accuracy of the reports. There could definitely be liability issues for the software vendor, should the institution be penalized for incorrect 5498 reporting. Software vendors who are providing incorrect 5498s will hopefully make the necessary corrections to their software program.

IRS GUIDANCE — FAIR MARKET VALUE (FMV) OF STOCKS AND BONDS

The value of stocks and bonds is the FMV of a share or bond on the valuation date.

Selling prices on valuation date. If there is an active market for the contributed stocks or bonds on a stock exchange, in an over-the-counter market, or elsewhere, the FMV of each share or bond is the average price between the highest and lowest quoted selling prices on the valuation date. For example, if the highest selling price for a share was $11, and the lowest $9, the average price is $10. You get the average price by adding $11 and $9 and dividing the sum by 2.

No sales on valuation date. If there were no sales on the valuation date, but there were sales within a reasonable period before and after the valuation date, you determine FMV by taking the average price between the highest and lowest sales prices on the nearest date before and on the nearest date after the valuation date. Then you weight these averages in inverse order by the respective number of trading days between the selling dates and the valuation date.

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TAKING A LOOK AT SAFE HARBOR 401(k) PLANS AND SIMPLE 401(k) PLANS

In order to understand the possible advantages of adopting or converting to either a Safe Harbor 401(k) Plan or SIMPLE 401(k) Plan, let's take a brief look at the challenges facing a non-safe harbor plan. Every year, an employer who sponsors a 401(k) plan must have their plan tested to ensure it meets the general nondiscrimination requirements set forth in Internal Revenue Code 401(a)(4). Two of these tests are the Actual Deferral Percentage Test and the Actual Contribution Percentage Test, more commonly referred to as the ADP and ACP tests. The ADP test limits highly compensated employees (HCEs) to a level of elective deferrals that is not excessively above the level chosen by non-highly compensated employees (NHCEs). Similarly, the ACP test ensures that HCEs do not utilize matching and employee after-tax contributions substantially more than the NHCEs. If the plan fails either one of these tests, corrective measures must be taken, or the Plan risks losing its qualification. In most cases, a failed ADP or ACP test is corrected through the return of excess contributions to the HCEs. Unfortunately, this means the person administering the plan must tell the HCE(s) (usually the owner or his/her boss) that a portion of their elective deferrals made in the past year will have to be returned to them. If this isn't dreadful enough, they may even have to notify the HCE(s) that they are required to amend their tax return, depending on the timing of the correction. Alternatively, the employer may elect to make additional contributions to the NHCEs to ensure the ADP and ACP tests are satisfied.

As a means of avoiding the dilemma outlined above, a growing number of employers are adopting or converting to a Safe Harbor 401(k) Plan or a SIMPLE 401(k) Plan.

Safe Harbor 401(k) Plans

The beauty of the Safe Harbor Plan is that it allows the HCEs to defer the maximum amount under law ($12,000 for 2003 and $13,000 for 2004) without having to worry about failing a nondiscrimination test. However, having this feature in a plan does come with a cost, as the employer must commit to providing a minimum employer contribution or a specified matching contribution. These contributions must also have certain characteristics as outlined below.

<u>Employers have two contribution choices</u>:

1. The Non-Elective Employer Contribution – Under this method, the employer is required to make a contribution of at least 3% of compensation to all eligible employees, whether they defer or not.
2. Employer Matching Contributions – (Basic or Enhanced Formula)

   Basic Formula – This method requires the employer to make a contribution of 100% of the employee's elective deferrals to the extent they do not exceed 3% of compensation, and 50% of the employee's elective deferrals between 3% and 5% of compensation.

   Enhanced Formula – This method may be used if, at any rate of elective deferrals, the matching contribution equals or exceeds the contribution under the basic formula (for example, matching contributions of 100% of elective deferrals up to 4% of compensation). In addition, the rate of matching contributions cannot increase as an employee's rate of elective deferrals increases.

   If the plan is top heavy, meaning more than 60% of the plan's assets are held by key employees, a properly designed Safe Harbor Plan does not require the employer to make the so-called top-heavy minimum required contributions. This is the case only when the employer makes no contributions other than one of those outlined above. Furthermore, if an employer wants to match more than the basic or enhanced amounts they may do so, but to satisfy the ACP safe harbor they are subject to further restrictions.

Safe Harbor contributions are subject to the following rules and issues:

- Vesting and Distribution Restrictions: The contributions must be 100% vested immediately, and can only be withdrawn in accordance with the rules applicable to a 401(k) plan. However, hardship is not considered a distributable event for the safe harbor contributions.
- No last-day or 1,000 hour requirement: The plan cannot require that a participant be employed on the last day of the plan year or work a minimum of 1,000 hours to receive a portion of the employer's non-elective or matching contribution. The employer must make the non-elective contribution to all employees who are eligible to make elective deferrals, and must make the safe harbor match to all employees who make elective deferrals.
- Employee After-Tax Contributions still included in ACP Test: Like a regular 401(k) plan, employee after-tax contributions must be taken into consideration when determining the plan's ACP.
- Plan Language: The plan document must indicate whether the employer intends to use the non-elective contribution or the matching formula to satisfy the safe-harbor requirements.
- Notice to Participants: Existing 401(k) plans must provide a Safe-Harbor Notice to participants 30-90 days before the start of the plan year; otherwise the plan is not eligible to use the safe harbor provisions for the entire year. New 401(k) plans, or existing plans that are adding a 401(k) feature for the first time, must provide such notice at least 3 months

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before the end of the current plan year.

SIMPLE 401(k) Plans

SIMPLE 401(k) Plans have many similarities to the Safe-Harbor 401(k) Plan, but they are available only to small employers, and are more limited in the amount that can be contributed. An eligible employee may elect to defer a maximum of $8,000 for 2003 and $9,000 for 2004. If the plan allows catch-up contributions, those participants 50 or over can contribute an additional $1,000 for 2003 and $1,500 for 2004.

SIMPLE 401(k) Plans satisfy the ADP and ACP tests if the following requirements are met:

- The Plan Sponsor must be an "eligible employer": An employer that had no more than 100 employees who received at least $5,000 of compensation from the employer for the preceding year.
- Must be a Calendar-Year Plan: A plan operating on a fiscal year is not permitted to adopt a SIMPLE 401(k) Plan.
- Exclusive Plan Requirement: A SIMPLE 401(k) Plan can only be adopted by an employer who does not sponsor another plan that benefits employees who are eligible to participate under the 401(k) plan.
- Employer Contributions: The employer must make non-elective contributions of 2% of compensation for each eligible employee who received at least $5,000 of compensation for the plan year; or
- The employer must make a 100% matching contribution on elective deferrals up to 3% of the participant's compensation.
- Vesting: Like the Safe Harbor 401(k) Plan, all contributions are 100% vested immediately.
- Plan Language: The plan should be written to indicate that the employer is relying on the SIMPLE 401(k) approach to satisfy ADP and ACP testing.
- Election and Notice Requirements:

  Each eligible employee may make or modify a salary-reduction agreement during the 60-day period immediately preceding each January 1 and may elect to terminate the salary reduction agreement at any time during the year.

  Prior to the 60-day election period described above, notification must be given to the participants indicating whether the employer will make a 2% non-elective contribution or provide a 3% matching contribution.
- Relief from Top-Heavy Requirements: This feature is also similar to that found in a Safe Harbor 401(k) Plan.

Like most rules and regulations related to 401(k) plans, these rules aren't all that simple. We have assisted a number of employers and their financial advisors regarding these plans by designing their plan to achieve their objective. If you think a Safe Harbor 401(k) Plan or a SIMPLE 401(k) Plan may be for you or your client, please contact one of our consultants.

The following chart offers a side-by-side comparison of the attributes of a regular 401(k) plan, a Safe-Harbor 401(k) plan and a SIMPLE 401(k) plan.

Question/Topic	Regular 401(k) Plan	Safe Harbor 401(k) Plan	SIMPLE 401(k) Plan
Who can establish?	Corporations, Sub-Chapter S, Sole Proprietorships, Self-Employed, Partnerships	Same as a regular 401(k) plan.	Same as a regular 401(k) plan, except plan can only be adopted by an employer with 100 or ewer employees who had compensation of at least $5,000 in the prior year.
Eligibility Requirements	Plan may exclude any group of employees, so long as the plan can still pass the various nondiscrimination tests. With respect to age and service, the plan may require attainment of age 21 and one year of service.	Same as a regular 401(k) plan.	Same as a regular 401(k) plan.
What is the plan year?	Any 12-month period designated by the employer.	Same as a regular 401(k) plan.	Must be a calendar year.
What limit applies to elective salary deferral contributions?	$12,000 for 2003 and increasing by $1,000 for each year, up to $15,000 in 2006.	Same as a regular 401(k) plan.	$8,000 for 2003, $9,000 for 2004 and $10,000 for 2005.
Catch-Up contributions for workers age 50 and older.	$2,000 for 2003 and increasing by $1,000 for each year until reaching $5,000 in 2006.	Same as a regular 401(k) plan. None	$1,000 for 2003 and increasing by $500 for each year until reaching $2,500 in 2006.
What no-discrimination tests apply to elective deferrals and the employer match.	The ADP and ACP tests.	Yes	Non
Are employer contributions mandatory?	No	Both employee and employer contributions are always 100% vested.	Yes
Vesting	Elective deferral contributions are always 100% vested. Employer contributions vest according to the plan's vesting schedule.		Both employee and employer contributions are always 100% vested.
Plan loans available?	Yes	Yes	Yes
Are distributions subject to 10% early penalty tax.	Yes	Yes	Yes

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Listings on more than one stock exchange. Stocks or bonds listed on more than one stock exchange are valued based on the prices of the exchange on which they are principally dealt. This applies if these prices are published in a generally available listing or publication of general circulation. If this is not applicable, and the stocks or bonds are reported on a composite listing of combined exchanges in a publication of general circulation, use the composite list. See also Unavailable prices or closely held corporation, later.

Bid and asked prices on valuation date. If there were no sales within a reasonable period before and after the valuation date, the FMV is the average price between the bona fide bid and asked prices on the valuation date.

Example. Although there were no sales of Blue Corporation stock on the valuation date, bona fide bid and asked prices were available on that date of $14 and $16 respectively. The FMV is $15, the average price between the bid and asked prices.

No prices on valuation date. If there were no prices available on the valuation date, you determine FMV by taking the average prices between the bona fide bid and asked prices on the closest trading date before and after the valuation date. Both dates muse be within a reasonable period. Then you weight these averages in inverse order by the respective number of trading days between the bid and asked dates and the valuation date.

Prices only before or after valuation date, but not both. If no selling prices or bona fide bid and asked prices are available on a date within a reasonable period before the valuation date, but are available on a date within a reasonable period after the valuation date, or vice versa, then the average price between the highest and lowest of such available prices may be treated as the value.

Large blocks of stock. When a large block of stock is put on the market, it may lower the selling price of the stock if the the supply is greater than the demand. On the other hand, market forces may exist that will afford higher prices for large blocks of stock. Because of the many factors to be considered, determining the value of large blocks of stock usually requires the help of experts specializing in underwriting large quantities of securities, or in trading in the securities of the industry of which the particular company is a part.

Unavailable prices or closely held corporation. If selling prices or bid and asked prices are not available, or if securities of a closely held corporation are involved, determine the FMV by considering the following factors:

1. For bonds, the soundness of the security, the interest yield, the date of maturity, and other relevant factors.

2. For shares of stock, the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors.

Other factors. Other relevant factors include the goodwill of the business, the economic outlook in the particular industry, the company's position in the industry and its management, and the value of securities of corporations engaged in the same or similar business. For preferred stock, the most important factors are its yield, dividend coverage, and protection for its liquidation preference.

You should keep complete financial and other information on which the valuation is based. This includes copies of reports of examinations of the company made by accountants, engineers, or any technical experts on or close to the valuation date.

Restricted securities. Some classes of stock cannot be traded publicly because of restrictions imposed by the Securities and Exchange commission, or by the corporate charter or a trust agreement. These restricted securities usually trade at a discount in relation to freely traded securities.

To arrive at the FMV of restricted securities, factors that you must consider include the resale provisions found in the restriction agreements, the relative negotiating strengths of the buyer and seller, and the market experience of freely traded securities of the same class as the restricted securities.

Example: FMV of an IRA Owning Real Estate

An individual had approximately $50,000 in an IRA in 1994. He elected and instructed to have his IRA purchase a house in the following manner. The IRA purchased the house for $60,000. The IRA made a down payment of $25,000 and borrowed the remaining $35,000 at 8% for 10 years. The house was rental property from 1994 - 2002. The house was rented to a number of unrelated third parties. The IRA has paid all maintenance and tax expenses. The balance of the loan as of 12/31/02 was $8,000. An appraiser has determined that the current market value of the house as of 12/31/02 is $96,000. The other assets in the IRA as of 12/31/02 had a fair market value of $28,000. For purposes of this discussion, it is assumed that the IRA accountholder did not make any additional contributions to this IRA.

Note that the fair market value of the IRA was originally $50,000. When the house was first purchased for $60,000, the fair market value of the IRA did not change. Only the IRA's investments had changed.

The fair market value of the IRA as of 12/31/02 is determined as follows:

$96,000 + $28,000 - $8,000 = $116,000. There has been an increase of $66,000 in the fair market value of the IRA since 1994. Much of this increase is attributable to the gain on the house investment ($96,000 - $50,000).

Any debt within an IRA will need to be netted against the value of the IRA's assets to determine the IRA's fair market value.

TEN-YEAR AVERAGING

Most distributions from pension plans (not IRAs) are reported on lines 16(a) and 16(b) of Form 1040, and thereby taxed as ordinary income at the participant's marginal tax rate. Individuals born before 1936 may be eligible to elect optional methods of figuring the tax on lump-sum distributions from a qualified retirement plan. For a plan participant who satisfies certain requirements, special tax treatment is afforded on Form 4972 and can result in significant tax savings to the individual. A distribution will qualify as a lump-sum distribution if it meets the following requirements:

1. The distribution(s) must be within a single tax year of a plan participant's entire balance from all of the employer's qualified plans of one kind (Keogh, profit-sharing or 401(k) are aggregated). The participant's entire balance from a plan does not include certain forfeited amounts. It also does not include any deductible voluntary employee contributions allowed by the plan after 1981 and before 1987;

2. The distribution is made on account of death, attainment of age $59\frac{1}{2}$, separation from service (does not apply to a self-employed individual) or disability (applies only to a self-employed individual);

3. The participant has participated in the plan for five or more tax years before the tax year of distribution (unless the distribution is paid out because of the participant's death).

Distributions that do not qualify for Form 4972:

1. A distribution from an IRA, SEP, SAR-SEP or a tax-sheltered annuity (section 403(b) plan);

2. A distribution that is partially rolled over to another qualified plan or an IRA;

3. Any distribution if an earlier election to use either 5 year averaging or 10 year averaging was made after 1986 for the same participant;

4. U.S. Retirement Plan Bonds distributed with the lump sum;

5. A distribution from a qualified plan that received a rollover after 2001 from an IRA (other than a conduit IRA), a governmental section 457 plan, or a section 403(b) tax-sheltered annuity on behalf of the participant;

6. A distribution from a qualified plan that received a rollover after 2001 from another qualified plan on behalf of that participant's surviving spouse.

What tax options are available to a participant who qualifies for lump-sum treatment?

1. A participant can elect to treat the portion of the distribution attributable to active participation in the plan prior to 1974 as long-term capital gain taxed at a rate of 20%. The participant can elect to figure the remainder of the distribution using 10-year income averaging.

2. 10 –year income averaging can be used for the entire distribution.

3. The taxes on the distribution may be deferred by a rollover into an IRA or to another qualified retirement plan. As noted earlier, a rollover eliminates the possibility of any future special tax treatment of the distribution.

4. Ordinary income tax can be paid on the entire distribution.

Determining the Capital Gain Portion of a Lump-Sum Distribution

To calculate what portion of the lump-sum distribution is attributable to pre1974 participation, this calculation is made:

1. The capital gain portion equals the total taxable amount times the fraction (months of active participation before 1974 divided by the total number of months of active participation).
2. The ordinary income portion equals the total taxable amount times the fraction (months of active participation after 1973 divided by the total number of months of active participation).
3. There are special rules to calculate the total number of months of participation. If a person was a participant for any part of a year prior to 1974, he or she is credited with 12 months of participation. After 1973, a person is credited with a month of participation for any part of a month he or she was a participant.

Example: Jane Smith has maintained her Keogh plan since October of 1969. If she elected to take a distribution in June of 2002 when her account balance was $150,000, the calculation of the capital gain portion and the ordinary income portion would be as follows:

$$\text{Capital Gain Portion} = \$150{,}000 * \frac{\text{Months Prior to 1974}}{\text{Total Months}}$$

Months Prior to 1974 = 60 months

Total Months = 402

1969 – 1970	24	months
1971 – 2000	360	months
2001 – June 2002	18	months
	40	months

Capital Gain Portion = $150,000 * 60/402 = $22,388

Ordinary Income Portion = $150,000 - $22,388 = $127,612

Note: A self-employed individual is entitled to capital gain treatment only if 10-year averaging is also elected.

Example of tax determination using Ten Year Averaging and Capital Gain Treatment and Ten Year Averaging only:

The actual tax calculation (using the 2002 Form 4972) for each of these alternatives is set forth on the next two pages. Above, it was calculated that the capital gain portion of the $150,000 distribution was $22,388 and the ordinary income portion was $127,612.

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Ten-Year Averaging, Continued from page 7

The summary of the results is set forth below:

- Jane Smith elects to go with capital gain on the portion which qualifies and 10 year average the remainder. Her tax liability would be $24,188.
- Jane Smith elects to 10 year average the entire distribution. Her tax liability would be $24,570.

In this scenario, Ms. Smith would obviously choose to use capital gain treatment since it results in a lower tax liability. However, she may wish to consider including the entire amount as ordinary income if she had substantial tax losses for the year to offset against her income.

Seek Professional Assistance Prior to Actual Distribution

The tax rules which apply to pension distributions (whether lump sum or not) are complex. Any participant receiving a pension plan distribution should seek competent professional assistance prior to the actual distribution. Further compounding the issue is the recent enactment of the Jobs and Growth Tax Relief Reconciliation Act of 2003 which was passed by Congress just days before Memorial Day.

10-YEAR AVERAGING "WITH" CAPITAL GAIN OPTION

Form **4972** — **Tax on Lump-Sum Distributions**
(From Qualified Plans of Participants Born Before January 2, 1936)
► Attach to Form 1040 or Form 1041.
Department of the Treasury
Internal Revenue Service
OMB No. 1545-0193
2002
Attachment Sequence No. 28

Name of recipient of distribution: JANE A. SMITH
Identifying number: 444-44-4444

Part I — Complete this part to see if you can use Form 4972

		Line	Yes	No
1	Was this a distribution of a plan participant's entire balance (excluding deductible voluntary employee contributions and certain forfeited amounts) from all of an employer's qualified plans of one kind (pension, profit-sharing, or stock bonus)? If "No," **do not** use this form	1	X	
2	Did you roll over any part of the distribution? If "Yes," **do not** use this form	2		X
3	Was this distribution paid to you as a beneficiary of a plan participant who was born before January 2, 1936?	3		X
4	Were you **(a)** a plan participant who received this distribution, **(b)** born before January 2, 1936, **and (c)** a participant in the plan for at least 5 years before the year of the distribution?	4	X	
	If you answered "No" to both questions 3 **and** 4, **do not** use this form.			
5a	Did you use Form 4972 after 1986 for a previous distribution from your own plan? If "Yes," **do not** use this form for a 2002 distribution from your own plan	5a		X
b	If you are receiving this distribution as a beneficiary of a plan participant who died, did you use Form 4972 for a previous distribution received for that participant after 1986? If "Yes," **do not** use the form for this distribution	5b		X

Part II — Complete this part to choose the 20% capital gain election (see instructions)

6	Capital gain part from Form 1099-R, box 3	6	22,388
7	Multiply line 6 by 20% (.20) ►	7	4,478
	If you also choose to use Part III, go to line 8. Otherwise, include the amount from line 7 in the total on Form 1040, line 42, or Form 1041, Schedule G, line 1b, whichever applies.		

Part III — Complete this part to choose the 10-year tax option (see instructions)

8	Ordinary income from Form 1099-R, box 2a minus box 3. If you did not complete Part II, enter the taxable amount from Form 1099-R, box 2a	8	127,612
9	Death benefit exclusion for a beneficiary of a plan participant who died before August 21, 1996	9	
10	Total taxable amount. Subtract line 9 from line 8	10	127,612
11	Current actuarial value of annuity from Form 1099-R, box 8. If none, enter -0-	11	
12	Adjusted total taxable amount. Add lines 10 and 11. If this amount is $70,000 or more, **skip** lines 13 through 16, enter this amount on line 17, and go to line 18	12	127,612
13	Multiply line 12 by 50% (.50), but **do not** enter more than $10,000	13	
14	Subtract $20,000 from line 12. If line 12 is $20,000 or less, enter -0-	14	
15	Multiply line 14 by 20% (.20)	15	
16	Minimum distribution allowance. Subtract line 15 from line 13	16	
17	Subtract line 16 from line 12	17	127,612
18	Federal estate tax attributable to lump-sum distribution	18	
19	Subtract line 18 from line 17. If line 11 is zero, **skip** lines 20 through 22 and go to line 23	19	127,612
20	Divide line 11 by line 12 and enter the result as a decimal (rounded to at least three places)	20	.
21	Multiply line 16 by the decimal on line 20	21	
22	Subtract line 21 from line 11	22	
23	Multiply line 19 by 10% (.10)	23	12,761
24	Tax on amount on line 23. Use the Tax Rate Schedule in the instructions	24	1,971
25	Multiply line 24 by ten (10). If line 11 is zero, **skip** lines 26 through 28, enter this amount on line 29, and go to line 30	25	19,710
26	Multiply line 22 by 10% (.10)	26	
27	Tax on amount on line 26. Use the Tax Rate Schedule in the instructions	27	
28	Multiply line 27 by ten (10)	28	
29	Subtract line 28 from line 25. Multiple recipients, see instructions. ►	29	19,710
30	**Tax on lump-sum distribution.** Add lines 7 and 29. Also include this amount in the total on Form 1040, line 42, or Form 1041, Schedule G, line 1b, whichever applies ►	30	24,188

For Paperwork Reduction Act Notice, see instructions. Cat. No. 13187U Form **4972** (2002)

10-YEAR AVERAGING "WITH" CAPITAL GAIN OPTION

Form **4972** — **Tax on Lump-Sum Distributions**
(From Qualified Plans of Participants Born Before January 2, 1936)
► Attach to Form 1040 or Form 1041.
Department of the Treasury
Internal Revenue Service
OMB No. 1545-0193
2002
Attachment Sequence No. 28

Name of recipient of distribution: JANE A. SMITH
Identifying number: 444-44-4444

Part I — Complete this part to see if you can use Form 4972

		Line	Yes	No
1	Was this a distribution of a plan participant's entire balance (excluding deductible voluntary employee contributions and certain forfeited amounts) from all of an employer's qualified plans of one kind (pension, profit-sharing, or stock bonus)? If "No," **do not** use this form	1	X	
2	Did you roll over any part of the distribution? If "Yes," **do not** use this form	2		X
3	Was this distribution paid to you as a beneficiary of a plan participant who was born before January 2, 1936?	3		X
4	Were you **(a)** a plan participant who received this distribution, **(b)** born before January 2, 1936, **and (c)** a participant in the plan for at least 5 years before the year of the distribution?	4	X	
	If you answered "No" to both questions 3 **and** 4, **do not** use this form.			
5a	Did you use Form 4972 after 1986 for a previous distribution from your own plan? If "Yes," **do not** use this form for a 2002 distribution from your own plan	5a		X
b	If you are receiving this distribution as a beneficiary of a plan participant who died, did you use Form 4972 for a previous distribution received for that participant after 1986? If "Yes," **do not** use the form for this distribution	5b		X

Part II — Complete this part to choose the 20% capital gain election (see instructions)

6	Capital gain part from Form 1099-R, box 3	6	
7	Multiply line 6 by 20% (.20) ►	7	
	If you also choose to use Part III, go to line 8. Otherwise, include the amount from line 7 in the total on Form 1040, line 42, or Form 1041, Schedule G, line 1b, whichever applies.		

Part III — Complete this part to choose the 10-year tax option (see instructions)

8	Ordinary income from Form 1099-R, box 2a minus box 3. If you did not complete Part II, enter the taxable amount from Form 1099-R, box 2a	8	150,000
9	Death benefit exclusion for a beneficiary of a plan participant who died before August 21, 1996	9	
10	Total taxable amount. Subtract line 9 from line 8	10	150,000
11	Current actuarial value of annuity from Form 1099-R, box 8. If none, enter -0-	11	
12	Adjusted total taxable amount. Add lines 10 and 11. If this amount is $70,000 or more, **skip** lines 13 through 16, enter this amount on line 17, and go to line 18	12	150,000
13	Multiply line 12 by 50% (.50), but **do not** enter more than $10,000	13	
14	Subtract $20,000 from line 12. If line 12 is $20,000 or less, enter -0-	14	
15	Multiply line 14 by 20% (.20)	15	
16	Minimum distribution allowance. Subtract line 15 from line 13	16	
17	Subtract line 16 from line 12	17	150,000
18	Federal estate tax attributable to lump-sum distribution	18	
19	Subtract line 18 from line 17. If line 11 is zero, **skip** lines 20 through 22 and go to line 23	19	150,000
20	Divide line 11 by line 12 and enter the result as a decimal (rounded to at least three places)	20	.
21	Multiply line 16 by the decimal on line 20	21	
22	Subtract line 21 from line 11	22	
23	Multiply line 19 by 10% (.10)	23	15,000
24	Tax on amount on line 23. Use the Tax Rate Schedule in the instructions	24	2,457
25	Multiply line 24 by ten (10). If line 11 is zero, **skip** lines 26 through 28, enter this amount on line 29, and go to line 30	25	24,570
26	Multiply line 22 by 10% (.10)	26	
27	Tax on amount on line 26. Use the Tax Rate Schedule in the instructions	27	
28	Multiply line 27 by ten (10)	28	
29	Subtract line 28 from line 25. Multiple recipients, see instructions. ►	29	24,570
30	**Tax on lump-sum distribution.** Add lines 7 and 29. Also include this amount in the total on Form 1040, line 42, or Form 1041, Schedule G, line 1b, whichever applies ►	30	24,570

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