THE Pension Digest

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ALSO IN THIS ISSUE –

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

Right to Treat as Own: Limited Exception or a Major New Rule?

A right of a surviving spouse to treat his or her deceased spouse's IRA as his or her own IRA is a very valuable tax (planning) right. When the surviving spouse elects to treat the decedent's IRA as his or her own, it becomes the surviving spouse's own IRA and is no longer an inherited IRA subject to the RMD rules which apply to inherited IRAs.

One of the reasons this right is so important is because too often the proper tax/wealth planning is not accomplished prior to an accountholder's death. When a surviving spouse has the right to treat the decedent's IRA as his or her own, some post-mortem planning can be accomplished.

This right of a surviving spouse to elect to treat a deceased spouse's IRA as their own was first created by the IRS when it issued an IRA Regulation in the 1970s. In the last five years or so, the IRS had concluded that there should be a cutting-back of a surviving spouse's right to treat the decedent's IRA as his or her own. The IRS concluded that this right should exist only if the surviving spouse was the sole beneficiary of the IRA and only if the surviving spouse has an unlimited right to withdraw the principal and interest of the IRA. The IRS wrote the 2001 proposed regulation accordingly.

In April of 2002, the IRS issued the final RMD regulations. There was a very important change. The IRS acknowledged in the regulation's preamble that even though a surviving spouse is not eligible to elect to treat the decedent's IRA as his or her own, that he or she is eligible to roll over such funds, as long as the other rollover rules are satisfied. The Preamble to the "Final Regulations" provides, in relevant part, that, "if a surviving spouse actually receives a distribution from an IRA that was the property of a deceased individual, the surviving spouse is permitted to roll over that distribution within 60 days into an IRA in his or her own name to the extent that the distribution is not a required distribution, regardless of whether the surviving spouse is the sole direct beneficiary of the IRA owner."

The final RMD regulations create the general rule that a surviving spouse does not have the right to treat the decedent's IRA as his or her own when the IRA passes through an estate, even if the spouse is the sole beneficiary of the estate. The regulation seems to be quite clear on the subject. There is no ability to roll over or treat the deceased spouse's IRA as his or her own when the surviving spouse is not the sole beneficiary of the IRA. And if the estate or a trust is the beneficiary of the IRA, then the spouse is not the sole beneficiary.

On March 18, 2003, the IRS issued Private Letter Ruling 200324059. Surprising to us, the IRS chose NOT apply its general rule. The general rule provides that it is the estate which is the payee of IRA proceeds. Consequently, a subsequent distribution by the estate to a beneficiary does not qualify for rollover treatment. In this case, where the surviving spouse is the sole personal representative of the decedent's estate, the IRS concluded the surviving spouse would be treated as the payee of the IRA proceeds for IRA rollover purposes.

The question now is, will the IRS choose not to apply the general rule in other similar situations. The IRS ruled the "general rule will not apply in a case where the surviving spouse is the sole personal representative of the decedent's estate who must pay the decedent's IRA to herself as sole intestate beneficiary of the estate, and who, after such payment rolls them into an IRA set up and maintained in her name."

The only distinguishing fact in this PLR is that the surviving spouse was also the sole personal representative of the decedent's

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Right to Treat as Own, Continued from page 1

estate. Is this difference a sufficient reason to now allow the surviving spouse to do a rollover?

We don't think so, but one should not complain when the IRS rules in the taxpayer's favor. One would have thought the IRS would have written the proposed regulation and the final regulation to authorize what has been allowed by prior PLRs, because the IRS had considered and issued numerous PLRs on similar, if not identical situations from 1984-2000. The IRS had chosen to not do so. This gave the idea the IRS was cutting back on the right of a surviving spouse to elect to treat the deceased spouse's IRA as his or her own or to roll over the IRA funds to his or her own IRA. But then the IRS, in the final regulation, gave the idea that it was cutting back on the spouse's right to "treat as own" by stating that a surviving spouse has the right to do a roll over even if he or she does not have the right to treat the decedent's IRA as his or her own. If things don't seem clear, it is because they are not.

Is the IRS creating a new major rule? It appears the IRS has created a major new rule, although it is a little early to conclude this. It will be necessary to see if the IRS will issue additional private letter rulings reaching the same conclusion. Taxpayers who wish to use this rule should seek their own private letter ruling, because this ruling could be found to be inconsistent with a number of the rules set forth in the final RMD regulation. As we all know, a private letter ruling is just that, and it may not be cited by others as precedent to bind the IRS. Most tax professionals, however, are willing to adopt these changes as new rules if the IRS continues to issue private letter rulings which adopt the same tax arguments and conclusions.

Page 2 of PLR 200324059 sets forth the following facts:

"Taxpayer A was born on Date 1, 1931, and died on Date 2, 2001 without having attained age 70½. Taxpayer B, who was born on Date 3, 1942, is the surviving wife of Taxpayer A. At his death, Taxpayer A maintained IRA X, with Trustee C. Taxpayer A had designated his prior spouse, Individual D, as the beneficiary of his IRA X, but Individual D predeceased Taxpayer A. The date of death value of IRA X was Value 1.

The account agreement of IRA X provides, in pertinent part, that if an account owner designated a beneficiary, and the beneficiary predeceases the account owner, and the account owner does not designate another beneficiary, the account owner's estate will be the beneficiary.

No distributions have been made from IRA X either before or after the date of Taxpayer A's death. Your authorized representative asserts, on your behalf, that IRA X meets the requirements of Code section 408(a).

Taxpayer A died intestate. Under the laws of State F, Taxpayer B, as Taxpayer A's surviving spouse, has a priority claim to serve as the personal representative of Taxpayer A's estate. Taxpayer B has filed a petition for the probate of Taxpayer A's estate, and she has been appointed the sole personal representative of Taxpayer A's estate.

Pursuant to section 732.102 of the Statutes of State F, the intestate share of a decedent's surviving spouse is the entire intestate share if no lineal descendant of the decedent survives the decedent. Your authorized representative has asserted, on your behalf, that Taxpayer A was survived by no known living lineal descendants. Thus, pursuant to the above-referenced section of the State F Statutes, Taxpayer B's share of Taxpayer A's estate is the entire intestate estate including IRA X.

Taxpayer B, acting as sole personal representative of the estate of Taxpayer A, will cause Taxpayer A's IRA X to be distributed to the estate. Then in partial satisfaction of her claim to the intestate portion of Taxpayer A's estate, Taxpayer B will then pay the IRA X account balance to herself as sole intestate beneficiary of Taxpayer A's estate. Finally, Taxpayer B will roll over the process of IRA X into an IRA set up and maintained in her name. The rollover will be accomplished not later the 60th day following the date on which the IRA X distribution is made to Taxpayer A's estate. All expense and charges against Taxpayer A's estate will be paid from assets in the estate other than IRA X.

The above-referenced IRA X distribution and rollover will occur no later than December 31, 2003. "

Conclusion. In private letter ruling 200324059, the IRS applied a rule different from the rules set forth in the final regulation. Even though the estate was the decedent's IRA beneficiary, because the surviving spouse had total control by being both the sole beneficiary of the estate and the sole personal representative of the estate, the distribution was treated as having been made to the surviving spouse and not to the estate and was eligible to be rolled over. We will have to see if the IRS will apply this same "new" rule to a trust. That is, a rollover might also be permitted by a surviving spouse if he or she is the sole trustee of the trust as well as the sole beneficiary of the trust.

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Understanding Boxes 12 & 13 on the 2004 Form W-2

Set forth below are the IRS' written instructions for boxes 12 and 13. These boxes explain special codes to be used for certain types of elective deferrals, special expenses and special employer contributions. Box 13 informs the employee whether he or she is an active participant so special limits will apply to determine if the contributions to a traditional IRA will be deductible.

Note that there is a new Code W to be used when an employer makes a contribution to an employee's Health Savings Account.

Box 12. The following list explains the codes shown in box 12. You may need this information to complete your tax return. Elective deferrals (codes D, E, F, G, H, and S) under all plans are generally limited to $13,000 ($16,000 for section 403(b) plans if you qualify for the 15-year rule explained in Pub. 571). However, if you were at least age 50 in 2004, your employer may have allowed an additional deferral of up to $3,000 ($1,500 for section 401(k)(11) and 408(p) SIMPLE plans). This additional deferral amount is not subject to the overall limit on elective deferrals. For code G, the limit on elective deferrals may be higher for the last three years before you reach retirement age. Contact your plan administrator for more information. Amounts in excess of the overall elective deferral limit must be included in income. See the "Wages, Salaries, Tips, etc." line instructions for Form 1040.

Note: *If a year follows code D, E, F, G, H, or S, you made a make-up pension contribution for a prior year(s) when you were in military service. To figure whether you made excess deferrals, consider these amounts for the year shown, not the current year. If no year is shown, the contributions are for the current year.*

A—Uncollected social security or RRTA tax on tips. (Include this tax on Form 1040. See "Total Tax" in the Form 1040 instructions.)

B—Uncollected Medicare tax on tips. (Include this tax on Form 1040. See "Total Tax" in the Form 1040 instructions.)

C—Taxable cost of group-term life insurance over $50,000 (included in boxes 1, 3 (up to social security wage base), and 5)

D—Elective deferrals to a section 401(k) cash or deferred arrangement. Also includes deferrals under a SIMPLE retirement account that is part of a section 401(k) arrangement.

E—Elective deferrals under a section 403(b) salary reduction agreement

F—Elective deferrals under a section 408(k)(6) salary reduction SEP

G—Elective deferrals and employer contributions (including nonelective deferrals) to a section 457(b) deferred compensation plan

H—Elective deferrals to a section 501(c)(18)(D) tax-exempt organization plan (see "Adjusted Gross Income" in the Form 1040 instructions for how to deduct)

J—Nontaxable sick pay (information only, not included in boxes 1, 3, or 5)

K—20% excise tax on excess golden parachute payments (see "Total Tax" in the Form 1040 instructions)

L—Substantiated employee business expense reimbursements (nontaxable)

M—Uncollected social security or RRTA tax on taxable cost of group-term life insurance over $50,000 (former employees only) (see "Total Tax" in the Form 1040 instructions)

N—Uncollected Medicare tax on taxable cost of group-term life insurance over $50,000 (former employees only) (see "Total Tax" in the Form 1040 instructions)

P—Excludable moving expense reimbursements paid directly to employee (not included in boxes 1, 3, or 5)

R—Employer contributions to your Archer MSA (see **Form 8853,** Archer MSAs and Long-Term Care Insurance Contracts)

S—Employee salary reduction contributions under a section 408(p) SIMPLE (not included in box 1)

T—Adoption benefits (not included in box 1). You **must** complete **Form 8839,** Qualified Adoption Expenses, to compute any taxable and nontaxable amounts.

V—Income from exercise of nonstatutory stock option(s) (included in boxes 1, 3 (up to social security wage base), and 5)

W—Employer contributions to your Health Savings Account (see new **Form 8889,** Health Savings Accounts)

Box 13. If the "Retirement plan" box is checked, special limits may apply to the amount of traditional IRA contributions that you may deduct.

Note: *Keep* ***Copy C*** *of Form W-2 for at least 3 years after the due date for filing your income tax return. However, to help* ***protect your social security benefits,*** *keep* ***Copy C*** *until you begin receiving social security benefits, just in case there is a question about your work record and/or earnings in a particular year. Review the information shown on your annual (for workers over 25) Social Security Statement.*

a Control number | 22222 | Void ☐ | **For Official Use Only ►** **OMB No. 1545-0008**

b Employer identification number
1 Wages, tips, other compensation
2 Federal income tax withheld
c Employer's name, address, and ZIP code
3 Social security wages
4 Social security tax withheld
5 Medicare wages and tips
6 Medicare tax withheld
7 Social security tips
8 Allocated tips
d Employee's social security number
9 Advance EIC payment
10 Dependent care benefits
e Employee's first name and initial | Last name
11 Nonqualified plans
12a See instructions for box 12 Code
13 Statutory employee ☐ Retirement plan ☐ Third-party sick pay ☐
12b Code
14 Other
12c Code
12d Code
f Employee's address and ZIP code
15 State | Employer's state ID number | 16 State wages, tips, etc. | 17 State income tax | 18 Local wages, tips, etc. | 19 Local income tax | 20 Locality name

Form **W-2** **Wage and Tax Statement** 2004

Department of the Treasury—Internal Revenue Service

For Privacy Act and Paperwork Reduction Act Notice, see back of Copy D.

Copy A For Social Security Administration — Send this entire page with Form W-3 to the Social Security Administration; photocopies are **not** acceptable.

Cat. No. 10134D

Do Not Cut, Fold, or Staple Forms on This Page — Do Not Cut, Fold, or Staple Forms on This Page

IRS Issues 2004 Form 1099-Q and Instructions

The IRS has just released the 2004 Form 1099-Q. In the September 2003 issue of *The Pension Digest* we discussed the fact that the IRS was allowing the custodian/trustee to use either of two methods in completing this form. Method #1 is to complete box 1 (gross distribution), box 2 (earnings), and box 3 (basis). Method #2 is to complete box 1 (gross distribution), and insert the FMV amount in the large box underneath boxes 5 and 6. At your option, you may also insert a distribution reason code in this big box also. The instructions provide:

> **Distribution codes.** For 2004, the payer/trustee may, but is not required to, report (in the box below boxes 5 and 6) one of the following codes to identify the distribution you received: 1—Distributions (including transfers); 2—Excess contributions plus earnings taxable in 2004; 3—Excess contributions plus earnings taxable in 2003; 4—Disability; 5—Death; 6—Prohibited transaction.

This means that the CESA custodian, at this time, is not required to determine the earnings and basis portions of a gross distribution. We at CWF believe institutions should be working towards being able to make such a determination, as that is what the IRS would like custodians to do. The calculations are not difficult. On the other hand, everyone is busy with other tasks, and so it may be reasonable to delay this project until the IRS makes such reporting mandatory. It may be possible that the IRS never makes such reporting mandatory.

Set forth below is copy B (the Recipient's copy). Be aware that there are only two other copies prepared: copy A for the IRS, and copy C for the payer. This means it is not required to furnish a copy to the responsible individual in addition to mailing the copy B to the recipient child at the address of the responsible individual.

Common Data Processing Mistakes — Form 1099-R

The general rule for completing IRS Form 1099-R is that the same amount is to be placed in both Box 1 and Box 2a. Box 2(b), "Taxable Amount Not Determined," is to be checked. The IRS' rationale for this is that distributions from traditional IRAs are generally fully taxable. It is the individual taxpayer's responsibility to complete Form 8606 to substantiate a distribution which is not taxable. The IRS instructions are very clear that a financial institution has no duty to determine the deductible/nondeductible amount of any distribution (or contribution).

As is usually the case, there are always exceptions to the "general" rule. There are three cases in which Box 2a should not be completed with the same amount as Box 1—

Case #1: In the case of an excess contribution, only the INTEREST applicable to the excess contribution is reported in Box 2a. Note: The IRS treats a revoked IRA in the same manner as the withdrawal of an excess contribution.

Case #2: Recharacterizations — a 1099-R must be prepared, but Box 2a is completed with "0" in this situation.*

Case #3: Direct rollover from an IRA to employer pension plan. In this case, Code "G" is to used for years 2003 and forward, and Box 2a is completed with "0."*

***Note:** There is a difference between completing Box 2a with "0," and leaving it blank. Leaving Box 2a blank implies that the institution does not know the taxable amount of Box 1. Completing Box 2a with "0" informs the IRS that the amount in Box 1 is not taxable. Correspondingly, you will want to make sure that you do not check box 2(b)—taxable amount not determined.

Be aware that some data processors ALWAYS apply the general rule, which, as noted above, is not always correct. If your data processor does not have the capability to prepare the 1099-R for these special cases correctly, your institution will have to correct these forms. Most institutions will be able to correct the forms by preparing them manually, but those with more than 250 corrections must use magnetic media or the electronic method.

☐ 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

2004

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 transfer ☐

Copy B

For Recipient

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.

RECIPIENT'S name

Street address (including apt. no.)

City, state, and ZIP code

Account number (optional)

5 Check one:
- Qualified tuition program— Private ☐ or State ☐
- Coverdell ESA ☐

6 If this box is checked, the recipient is not the designated beneficiary ☐

If an **FMV** amount is shown below, see **Pub. 970,** Tax Benefits for Education, for how to figure earnings.

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

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Substitute Statements — 5498s for IRAs, Roth IRAs and Coverdell Accounts

The IRS, in Publication 1179, details the rules for substitute and consolidated statements. One important rule is that the statement must be identified as a substitute statement. Also, the form for which it is a substitute must also be identified (e.g. Substitute 5498, Substitute 5498-ESA, Substitute 5498-MSA).

A second rule which many software providers overlook is that the IRS instructions as prepared for the participant receiving the 5498, must be reproduced in its entirety. This may be easily provided by copying such onto the back of the substitute form, if there is not room on the front, or by providing an insert containing these instructions. Be aware that the Coverdell instructions (5498-ESA) differ from the other types of IRA Form 5498 instructions.

The Substitute 5498 should discuss Box 7 — the accountholder or beneficiary needs to be informed that you will be telling the IRS the type of IRA to which this statement applies. If only boxes 2, 4, or 5 are completed, you must indicate the type of IRA, because it is not self-evident if there have been no contributions during the year for which the 5498 is being prepared.

To be conservative, a substitute statement should also cover discussion of Box 11 "Check if RMD in 2004." You will check this box if your accountholder is required to receive a minimum distribution from the account in 2004.

Summary. Although substitute forms are permissible, the IRS has rules which must be followed in order to have a complying substitute form.

Understanding the Three RMD Tables

In general, required distributions must be made from an IRA for the year an IRA accountholder attains age 70½ and each subsequent year. Such distributions are to be made to the accountholder while he or she is alive and then to his or her beneficiary(ies) after the accountholder's death. In addition, if the accountholder dies before his or her required beginning date, then there will need to be required distributions as determined by using either the life-distribution rule or the five-year rule.

We write this article because a number of you have called our consulting service and you have asked various questions about the RMD tables. Many of you ask, "Are the use of tables really as simple as they seem to be?" The answer is "Yes." The IRS meant to make the rules simple and they did.

We hope this is a plain english explanation of when to use the various RMD tables.

The RMD tables are used to determine the distribution period (i.e. the divisor) in the RMD calculation formula: 12-31-xx account balance divided by the distribution period. Note the IRS decided to replace the term, "life expectancy" with "distribution period".

The IRS has issued three tables. Two of the tables are used to calculate the RMD for a living accountholder. These are the Uniform Lifetime Table and the Joint Life Table. The third table is only used to calculate the RMD for an inheriting beneficiary.

Table I. Uniform Lifetime Table (ULT).

This table is used to determine the divisor (i.e. the distribution period) for an IRA accountholder for all beneficiary situations with one major exception. You do NOT use this table when the IRA accountholder has designated his or her spouse as his or her sole beneficiary and the spouse is more than 10 years younger than the accountholder. <u>All beneficiary situations means all situations</u>. The ULT table is used in the following situations:

A. The accountholder designated his or her spouse as his or her sole beneficiary, but the spouse is the NOT more than 10 years younger (e.g. 75/68, 81/72, 75/70, etc).

B. The accountholder designated any person not his or her spouse to be the sole beneficiary. This could be a son, daughter, parent, brother, sister, grandparent, cousin, neighbor, former coach, fellow worker, etc.

The age of such beneficiary does NOT affect the RMD amount. The person could be 30 years older or 30 years younger than the accountholder.

C. The accountholder designated his spouse and another person or entity as his or her beneficiaries. That is, the spouse was not designated as the sole beneficiary.

D. The accountholder designated his or her estate as the IRA beneficiary.

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Understanding the Three RMD Tables, Continued from page 5

E. The accountholder designated his or her trust as the IRA beneficiary.

F The accountholder designated his church as the IRA beneficiary.

G. The accountholder designated the college from which he or she graduated as the IRA beneficiary.

Table II. The Joint Life Expectancy Table

This table is only used in the one special situation. The IRA accountholder has designated his or her spouse to be the sole beneficiary of his or her IRA and the spouse is more than 10 years younger than the accountholder. For purposes of this table it is assumed the spouse will not be younger than age 18. An illustrative table:

Age of Accountholder	Age of Spouse Beneficiary
70	18-59
71	18-60
72	18-61
73	18-62
74	18-63
75	18-64
76	18-65
77	18-66
78	18-67
79	18-68
80	18-69
81	18-70
82	18-71
83	18-72
84	18-73
85	18-74
86	18-75
87	18-76
88	18-77
89	18-78
90	18-79
91	18-80
Etc.	Etc.

Be aware a special rule applies when the IRA accountholder dies after his or her required beginning date. The RMD for the year of death is calculated as if the IRA accountholder had not died. To the extent the RMD was not distributed to the accountholder prior to his or her death, then such amount will need to be distributed to the beneficiary or beneficiaries in a pro rata manner by December 31 of such year.

Table III. The Single Life Table

This table is no longer used for living accountholder calculations, as it might have been under the pre-2002 RMD rules. It is now only used to determine the RMD for an inheriting IRA beneficiary who is using the life-distribution rule. Which life distribution rule is to be applied depends upon whether or not the spouse is the sole beneficiary and whether the accountholder died before or on/after his or her required beginning date.

Summary. Under the new RMD rules, it is very easy to determine which Table is to be used to determine an accountholder's RMD or a beneficiary's RMD. With the one exception, the RMD for a living accountholder is calculated using the Uniform Lifetime Table. That one exception is – the Joint Table is used when the spouse is the sole beneficiary who is more than 10 years younger.

The Single Table is always used to determine the distribution period for an inherited IRA subject to the life-distribution rule. Don't make RMD calculations more complicated than they are.

IRS Issues PLR 200349009

A trustee of a trust asked the IRS if it would be permissible to set up two inherited IRA accounts in the following situation.

The IRA accountholder (Jane Doe) died before her required beginning date. Her trust, Trust T, was the beneficiary of her IRA. Trust T is valid under the applicable state laws. Institution M is the custodian of this IRA. Individual D is the trustee of Trust T. Individual D has furnished the Institution M with the necessary information for RMD purposes.

Article 4 of Trust T provides that at the death of the IRA accountholder, the balance of Trust T, including the IRA, was to be given to Taxpayers B and C in equal shares. Taxpayers B and C are the daughters of the deceased IRA accountholder. Taxpayer B was born in 1963. Taxpayer C was born in 1966. There were no conditions placed on the distributions to be made to Taxpayer B. Numerous conditions were placed on the share of Taxpayer C. Her share was put into a subtrust. Individual D has sole and absolute discretion to use as much of the income or principal of the subtrust for Taxpayer C's benefit after considering T's other income. Upon C's death, the remaining assets of the subtrust are to be paid to Taxpayer C's descendants per stirpes. If C would have no descendants, then the remaining trust assets shall be paid to the IRA accountholder's surviving beneficiaries, per stirpes.

The trustee (individual D) has proposed setting up the following two inherited IRAs. The first inherited IRA would be titled, "Taxpayer B as beneficiary of Jane Doe's IRA." The second IRA would be titled, "the subtrust of Trust T as the beneficiary of Jane Doe's IRA."

The trustee would elect to use the life-distribution rule for both of these inherited IRAs. The distribution period for both inherited IRAs would be based on the age of Taxpayer B, the oldest beneficiary of the trust.

The reason for this letter request is that the final RMD regulation does not allow the separate accounting rule to be used by the beneficiaries of a trust.

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IRS Issues PLR 200349009, Continued from page 6

The IRS agrees with the request. The IRS, in this PLR, again makes clear that the rules of Rev. Ruling 78-406 apply to inherited IRAs as well as standard IRAs. The inherited IRA or IRAs must be set up and maintained in the name of the deceased accountholder, for the benefit of the beneficiary(ies). Although the RMD rules do preclude the use of the separate accounting rules, there are no rules (either in the Code or the RMD regulation) precluding the splitting of the deceased accountholder's IRA into two inherited IRAs.

Reporting for Rollovers and Direct Rollovers

Reporting a Roth Distribution — Check Made Payable to Accountholder. If an accountholder who is not yet age 59½ takes a distribution from his Roth IRA, and the check is made payable to him, how should your institution prepare the 1099-R to report this distribution to the IRS? According to IRS instructions, your institution should complete Box 1 with the gross amount of the distribution and leave Box 2a (taxable amount) blank. You would insert reason code "J" in Box 7. Reason code "J" is normally used for a Roth distribution when the accountholder has not yet attained age 59½.

Because the funds were made payable to the accountholder, this transaction cannot be titled as a transfer or a direct rollover. Therefore, if the accountholder does not roll over the funds to another IRA within the allowed 60-day period, the funds will be taxable to him as ordinary income.

If the transaction were a direct rollover, your institution would use reason code "G" (direct rollover/rollover), and would complete Box 2a with "0." Completing the 1099-R in this way in this case is incorrect, because a direct rollover, by definition, does not apply to any distribution from a Roth IRA. Internal Revenue Code 401(a)(31)(B) defines a direct rollover as a "direct transfer of an eligible rollover distribution."

In the case of a pension plan where the funds are moving from a pension plan to an IRA, a direct rollover is an easy way to move the funds, and that is when code "G" is used. There is no authority to define a direct rollover as the movement of funds from one Roth IRA to another Roth IRA, or from one traditional IRA to another traditional IRA. When funds are moved from an IRA to a pension plan, this is considered a direct rollover for reporting purposes.

When this accountholder completes his 2003 1040 tax return, line 15(a), (used whether a direct rollover or a rollover of a Roth distribution has taken place) should be completed with the gross amount of the distribution, and line 15(b) should be completed with "0," with "rollover" written next to it, if the funds were rolled over into another IRA within the allowed 60-day period. As the IRS knows, direct rollovers and rollovers are not taxable events; therefore, line 15(b) would be "0" in either case.

Backup Withholding Rates

In CWF's December newsletter, we set forth IRS Announcement 2003-45. The IRS informed the public that they had not yet had time to revise its many forms and publications to reflect the new backup withholding rate of 28%. The forms still reflect the rate of 30%.

Set forth below is a recent backup withholding notification sent to a bank. It is dated December 21, 2003. It still instructs that the bank begin backup withholding at the 30% rate.

> "Backup Withholding Notification
>
> The taxpayers named below or on the attached list are now subject to backup withholding under section 3406(a)(1)(c) of the Internal Revenue Code because of a notified payee underreporting.
>
> This is your notice to begin backup withholding at a rate of 30% on the dividend and/or interest payments you make to these taxpayers. Begin withholding no later than 30 days from the date of this letter and continue until the IRS notifies you in writing to stop. If a taxpayer is also currently subject to taxpayer identifying number (TIN) related backup withholding, that must remain in effect until we notify you that the taxpayer is no longer subject to any type of backup withholding. If you do not have an account for a listed individual, no action is required. It is not necessary to notify the IRS.
>
> If your organization is exempt from backup withholding requirements, please return this notice to the address above with a brief explanation.
>
> Important Note: Information in this notice about a payee's identity and account is only for your use in complying with the backup withholding regulations. If you give the information about one payee to another payee (for example, by mailing out copies of this notice), you may become liable for civil damages under the provisions of section 7431 of the Internal Revenue Code concerning the disclosure of personal information.
>
> Failure to withhold can result in civil and criminal penalties under Internal Revenue Code sections 6651, 6656, 6672, 7201, 7202, and 7203."

Now note this excerpt from IRS Publication 15-T (Rev. June 2003)—

> ***"Backup withholding.*** *Effective for payments after May 28, 2003 (or as soon as possible thereafter), the backup withholding rate is decreased to 28%. See the* ***General Instructions for Forms 1099, 1098, 5498, and W-2G,*** *for more information on backup withholding."*

Summary. Although the letter to the bank as detailed above (dated 12/21/03), states that the bank is to withhold 30% as backup withholding, Publication 15-T clearly states that after May 28, 2003, the rate to use for backup withholding is 28%. Therefore, CWF believes it is permissible for this bank to use the 28% rate in response to this IRS letter.

Retirement Plan Correction Programs

Did you know that the IRS has established programs for employers that sponsor tax-qualified retirement plans and wish to correct plan violations that raise qualification issues? These programs are consolidated under the Employee Plans Compliance Resolution System (EPCRS), and cover mistakes and errors in maintaining profit sharing plans, 401(k) plans, SEPs and SIMPLE IRA plans. The purpose of the programs is to encourage voluntary compliance by providing for limited fees for corrections approved by the IRS, thereby reducing employers' uncertainty regarding their potential liability and participant's potential tax liability. In some cases, the plan sponsor may be permitted to correct the error without IRS approval. While Revenue Procedure 2003-44 which governs EPCRS is very comprehensive, this article is intended to give you an overview of the programs.

Summary of Correction Programs Under EPCRS:

1. *Self-Correction (SCP).* A plan sponsor that has established compliance practices and procedures may at any time correct insignificant operational failures without notifying the IRS or paying any fee or sanction.

2. *Voluntary Correction Program (VCP).* This program can be used when the plan sponsor is not eligible to use SCP. Errors are corrected and the tax benefits of the plan are preserved for plan participants and the plan sponsor with IRS help and approval. The fee for utilizing this program is based on the number of participants. For profit sharing and 401(k) plans, the fee is $750 if there are 20 or fewer participants, and $1,000 for plans having 21 to 50 employees. The fee for SEPs and SIMPLE IRAs is a flat $500.

3. *Audit Closing Agreement Program (Audit CAP).* This program is used to correct errors with IRS approval when the plan is under examination. By making the correction, tax benefits are preserved for plan participants and sponsors with fees greater than those available under VCP, but less than the impact of the plan losing its tax benefits.

Types of Qualification Failures Covered Under EPCRS Programs:

1. *Operational Failure*—An "operational failure" is a failure to follow the terms of the plan document.

2. *Plan Document Failure*—A "plan failure" exists if a plan provision violates the requirements of 401(a) or if a qualification failure does not fall within one of the other categories of defects described under EPCRS.

3. *Demographic Failure*—A "demographic failure" is a failure to satisfy the nondiscrimination testing requirements of Section 401(a)(4) or the coverage requirements under Section 410(b), that requires a substantive amendment to the plan document to correct.

4. *Egregious Operational Failures*—An egregious failure occurs when a plan sponsor has consistently and improperly covered only highly compensated employees. It also could exist if a contribution to a defined contribution plan for a highly compensated employee is several times greater than the limit set forth in the regulations.

Although the correction programs have evolved favorably over the years to promote voluntary and timely correction of errors, plan sponsors should create compliance checklists and monitor administrative practices and procedures to enable prompt detection of errors. A plan sponsor that maintains good administrative practices and procedures should be reassured that mistakes in administering a plan may be corrected at a cost that is reasonable under the circumstances, utilizing procedures that are predictable and practical. Once errors are discovered, plan sponsors should correct them swiftly and completely, being mindful of IRS correction principles.