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ALSO IN THIS ISSUE –

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

The Naming of Inherited IRA Accounts

The IRS has given express instruction as to what to name an inherited account when the IRA accountholder dies. **But what name or title is used once the inheriting beneficiary dies?** At this point, the IRS has not yet given an express instruction as to what to name the inherited IRA account upon the death of the first inheriting beneficiary.

Examples #1 and #2 are set forth below to illustrate what names to use.

Example #1. Jane Wood maintained an IRA with First Classic Bank as the IRA custodian. Her date of birth was March 15, 1930. The December 31, 2002 value of her IRA was $60,000. She had designated her son, John Wood, to be her sole primary beneficiary. John's date of birth was August 4, 1962. She designated John's daughter, Sara, as her contingent beneficiary. Jane Wood died on 11/25/03. She had been paid her required distribution amount of $2,429.15, on November 1, 2003. John survives her, and he becomes the beneficiary owner of Jane's IRA. This inherited IRA will be titled, "First Classic Bank as IRA custodian for John Wood as beneficiary of Jane Wood's IRA." The abbreviated title for IRS reporting purposes is, "John Wood as beneficiary of Jane Wood's IRA." John assumes the tax attributes which Jane had in her IRA. If Jane had any nondeductible basis, then John assumes that nondeductible basis.

Since Jane Wood died after her required beginning date, John will be required to take a required distribution each year commencing with 2004. The life-distribution rule, as based upon John's age in 2004, will be used. The distribution period for 2004 will be 41.7, as based upon John's age of 42 years. For each subsequent year (even after John dies) the distribution period will be determined by subtracting 1 for each year after 2004. The distribution periods will be:

2004	41.7
2005	40.7
2006	39.7
2007	38.7
2008	37.7
2009	36.7
2010	35.7, etc.

Example #2. John designates his daughter, Sara Wood, as beneficiary of this inherited IRA. It is now assumed that John Wood dies in 2008. He had not yet been paid the RMD for 2008.

Sara has now (in 2008) inherited the inherited IRA of her dad, John. The original accountholder had been Jane Wood. For 2008 and subsequent years, Sara continues the distribution schedule which applied to John. Sara would be required to be paid the 2008 RMD by December 31, 2008. Sara, of course, can withdraw more than the RMD amount, if she desires.

How should this two-time inherited IRA now be titled?

Option #1 would be to title it: "Sara Wood as beneficiary of John Wood as beneficiary of Jane Wood's IRA."

Option #2 would be to title it: "Sara Wood as beneficiary of Jane Wood's IRA."

The second option is the one we recommend be used. The name of the inherited IRA should be: "Sara Wood as beneficiary of Jane Wood's IRA." It is not necessary to reference John Wood. The original reference to Jane Wood is necessary because the tax attributes of the inherited IRA are those which belonged to Jane Wood. It is true that the distributions made to John Wood will have resulted in a decrease to the original "basis," if applicable. Even so, we do not believe it is required or advisable to reference John Wood in the title.

Be Aware—Not All Mistakes are Correctable!

Mistakes are going to occur with respect to the making of IRA contributions. What is important for a financial institution to understand is that some of these mistakes are correctable, and some are not. It seems that many times, attorneys, accountants, IRA owners and management of the financial institution believe that virtually any mistake made with respect to traditional IRA and Roth IRA funds is correctable. This is definitely not true. Like it or not, sometimes an IRA custodian must tell an IRA owner and his or her adviser that it is impossible to correct a situation in the way they are proposing. We will discuss two examples in this article.

Example #1. "I made a Roth contribution, but my accountant changed her mind and prepared the tax return showing it was a traditional IRA contribution, but did not tell me."

John Taxpayer meets with his tax preparer, Ann Accountant, on April 1, 2003. She tells him he should make a $3,000 contribution to his Roth IRA for tax year 2002, and he agrees. He makes that contribution with your bank (First National Bank) that same day. Ann Accountant initially believed John would be ineligible to deduct the amount he contributed to a traditional IRA because she thought he was an active participant, and his income was too high. After John left her office, she determined that a contribution to a traditional IRA was deductible because his income was not so high as to disqualify him. Therefore, she prepared his tax return showing the $3,000 as having been contributed to an traditional IRA. Being super busy, she forgets to mention this to John Taxpayer. He returns to her office in April of 2004 to discuss the 2003 federal income tax return. She tells him then about how she treated the IRA contribution for tax year 2002. He now comes to your bank with the statement that his accountant has told him that he needs to change the contribution he made on April 1, 2003, for tax year 2002, from being a Roth contribution to a traditional IRA contribution.

Is this a problem which can be corrected by recharacterizing the contribution, or is it uncorrectable?

It is uncorrectable. John and the accountant are going to have to live with the fact that he made a contribution to a Roth IRA. The deadline for recharacterizing a contribution for tax year 2002 is October 15, 2003. After October 15, 2003, the 2002 contribution is not eligible to be recharacterized. In very rare situations, the IRS might be willing to grant special relief, but we do not think this situation would warrant that relief.

The individual or the tax preparer would have to amend the 2002 tax return to increase his income by $3,000 since he was not entitled to claim a $3,000 tax deduction because he did not make a contribution to a traditional IRA.

Remember, that generally a taxpayer does not report that he has made a Roth contribution. The taxpayer keeps track of his Roth IRA contribution on a worksheet which is not filed with the IRS. The IRA custodian does prepare a Form 5498 for the IRS and John showing a Roth IRA contribution was made and the amount.

Example #2. "My husband and I made two Roth IRA contributions but we later found out we were ineligible, and we now want them to be traditional IRA contributions."

Sara and Mike Taxpayer met with Davis Accountant, their tax preparer, on April 9, 2003. Mike and Sara were eligible to make contributions to their traditional IRAs, since neither was an active participant in an employer-sponsored plan. Mike and Sara both had wage income of $65,000 for 2002. In addition, Sara had dividend income of $40,000. Davis recommended that because Sara and Mike were relatively young, they should each contribute $3,500 to their respective Roth IRAs for tax year 2002. Sara is age 54, and Mike is age 52. They made these contributions with your bank (First National Bank) that same day. It is now July of 2004. Sara and Mike have just received a letter from the IRS informing them that they were ineligible to make the Roth IRA contributions of $7,000 for tax year 2002, because their modified adjusted gross income exceeded $160,000. The IRS assesses a tax bill of $420 plus interest and penalties ($3,500 x 6% x 2). In its letter, the IRS does not discuss the impact of such contributions on tax year 2003. Sara and Mike's modified adjusted gross income for 2003 is $180,000.

Will it be possible to avoid the $420 assessment by recharacterizing the 2002 contributions to be traditional IRA contributions for 2002?

The answer is "no." As discussed above, the deadline to recharacterize a 2002 contribution is October 15, 2003. That deadline is past. But December 31, 2003, is also past. December 31, 2003, was the deadline for correcting an excess contribution for 2003. Sara and Mike will have to pay, for 2003 purposes, another $420 ($3,500 x 6% x 2). Sara and Mike will want to withdraw the $7,000 in 2004, to avoid the 6% excise tax being assessed for 2004.

With respect to the 2003 tax year, it is assumed that Sara and Mike had contributed $3,500 per person to a Roth IRA on April 9, 2004. These contributions may be recharacterized to be traditional IRA contributions for 2003, since the deadline of October 15, 2004, has not expired. Sara and Mike will also need to file an amended return for 2003.

In summary, it is not always possible to change a contribution to a traditional IRA to be a contribution to a Roth IRA or vice versa. There are time deadlines which apply to correcting contributions by recharacterizations. The tax results can be harsh when one misses these deadlines.

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Iowa's Exemption Rules From Creditors—IRAs, Roth IRAs, SEP-IRAs, SIMPLE-IRAs and Self-Employed Keogh Plans

Overview

When a person is a debtor and he or she falls behind in making promised payments to a creditor, the creditor will look for ways to get paid. Many times a creditor will ask the question, "I believe John Doe has money in an IRA, SEP-IRA, Keogh plan or other employer-sponsored pension plan, is there any way that I can somehow reach that money so I can be paid the money I am owed?"

Creditors will try to reach IRA assets in two situations. First, a creditor will try to reach the assets of the debtor when the money is still in the IRA, Roth IRA, SEP-IRA, SIMPLE-IRA or pension plan. Secondly, the creditor will try to reach the assets once the funds have been paid out of such IRA or plans to the debtor.

Most states have a statute defining what property of a person (i.e. a debtor) is exempt from creditors. The public policy is that even though a debt is validly owed, there is to be a certain minimum amount which a debtor should be entitled to keep free from any creditor. Normally, such exemptions are only available to residents of the state. Iowa has statute section 627.6 (General Exemptions). This section provides a listing of the general property of an Iowa resident which is exempt from creditors. Such general exemption statutes can be quite interesting. For example, under Iowa law, a person's interest in his or her wedding ring or engagement ring is totally exempt from creditors if it was received on or before the date of the marriage. There is also an exemption for one shotgun and either one rifle or one musket. Although we find such laws interesting, the purpose of this newsletter is to illustrate laws affecting IRAs and other pension plans.

This article discusses the Iowa laws affecting IRAs, Roth IRAs, SEP-IRAs, SIMPLE-IRAs and self employed pension plans (i.e. Keoghs). These laws are subsections 626.7(8)(e) and (f) and sections 627.8 and 626.9. For those of you who are not from Iowa, you will benefit by understanding the approach of the Iowa laws. Your state may have similar approaches. An institution or other reader must consult with its attorney for specific situations.

In addition to state laws, the laws of the federal government must be considered in some situations.

Summary of Federal Laws

Federal law supersedes state law with respect to assets held by a section 401(a) plan (Qualified Plan). With very few exceptions, Code section 414 provides total protection to assets within a section 401(a) pension plan covering more than one participant from creditors (either the employer's or of any plan participant). One of the exceptions is that a qualified domestic relations order (QDRO) may affect plan assets to a certain degree. In general, once funds are distributed from a section 401(a) plan to a participant, a creditor of such participant could seek to be paid from those paid funds.

Since Iowa law has been superseded by federal law with respect to employer-sponsored pension plans (i.e. 401(k), profit sharing, etc), Iowa law primarily covers IRAs, Roth IRAs, SEP-IRAs, SIMPLE-IRAs and Keogh plans. There is no federal law providing protection to funds within a traditional IRA or a Roth IRA. The law is not yet settled with respect to whether a person in a multiple-participant SEP-IRA or SIMPLE-IRA plan is entitled to protection from creditors. At this point, most courts which have considered the issue have concluded that there is no federal law which protects assets in SEP-IRAs and SIMPLE-IRAS. In the opinion of CWF, these cases have been decided incorrectly. There is federal law clearly providing such protection. With respect to Keogh plans, the federal law is still evolving as to what degree, if any, a self-employed person is entitled to protection from creditors. See the article on page 7.

Summary of Iowa Exemption Laws

An exemption may be claimed by an Iowa resident for any payment from a pension or annuity if on account of illness, disability, death, age or length of service. The exemption is lost for contributions made within one year prior to the filing of a bankruptcy petition to the extent such contributions are in excess of those which are "normal and customary under the plan or contract."

This exemption certainly applies to payments from employer-sponsored pension plans, if the payment is made because the individual is disabled, has died or has reached a certain age, or if a length of service requirement has been met. It is not clear if it applies to distributions from IRAs, Roth IRAs, SEP-IRAs, SIMPLE-IRAs and one-person Keogh plans. Most likely it does not.

However, a debtor is not able to claim exemption for such payments if the legal claim has arisen on account of child, spousal or medical support (insurance) reasons. Most states have a similar provision.

If a person has a debt on account of failing to make child, spousal or medical support payments, the funds within an IRA, Roth IRA, SEP-IRA, SIMPLE-IRA or one-person Keogh plans will not be exempt from creditors. The public policy of providing for spousal and child support ranks higher than providing for retirement.

An exemption from execution shall apply to all money paid as a pension from the United States government to an Iowa resident. The exemption is automatic and follows the payment. The exemption continues to apply after payment, whether the person retains the payment, deposits it in the bank, loans it or invests it. Section 627.8.

An exemption may also be claimed by an Iowa resident for funds within an IRA, Roth IRA, SEP-IRA, SIMPLE-IRA and a self-

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Iowa's Exemption Rules, Continued from page 3

employed Keogh plan, when a creditor tries to reach such funds. However, there are limits to the amount which may be exempted. There are two limits — one for the contributions and one for the accumulated earnings with respect to the contributions, including increases in market value.

An exemption shall also apply to all transfers from a qualified plan as defined in Code section 401(a) to a succeeding trust authorized under federal law on or after April 25, 2001.

An exemption shall also apply to all transfers from a qualified plan as defined in code section 401(a) to a traditional conduit IRA, as well as any subsequent transfers from the traditional conduit IRA to another IRA, including an IRA annuity, Roth IRA or Roth IRA annuity.

An exemption shall apply to all transfers from an eligible retirement plan to an IRA, IRA annuity, Roth IRA or Roth IRA annuity. Such transfers shall also be exempt from the claims of creditors.

An eligible retirement plan is defined for this purpose to be: any retirement plan under federal or state law that can be transferred to an IRA, an IRA annuity, Roth IRA or Roth IRA annuity and are either exempt from execution under state or federal law or are excluded from a bankruptcy estate.

Assets within an IRA, IRA annuity, SEP-IRA, SARSEP-IRA, SIMPLE-IRA and self-employed pension plans, and similar plans authorized in the future under federal law are exempt, subject to the following special (and complicated) limits. We at CWF believe the legislators tried to do too much in this section, so it is not totally clear what they were trying to do. In fact, this section 626.6(f) is poorly written and needs to be rewritten. Here is our reading of this subsection.

There is a special limit for contributions. For each tax year in which there has been a contribution, the exemption shall not exceed the lesser of: (1) the actual amount deducted on the debtor's tax return or (2) the maximum amount ($2,000, $3,000 or $3,500 as applicable) which could be contributed to a traditional IRA and deducted for such year. These annual amounts are then added together to determine the total amount entitled to exemption. The problem with the statute is that is uses the "deduction" terminology. If a corporate employer makes a SEP contribution on behalf of a person, he or she may well not be entitled to claim any tax deduction, either with respect to the SEP contribution which is excluded from an employee's income or because no deduction is allowed because the person is an active participant. The reality: no exemption may be given for SEP, SIMPLE and self-employed Keogh contributions. In comparison, as mentioned previously, an employer's contribution to a qualified plan is totally exempt from creditors.

There is also a special limit for the accumulated earnings, including those earnings arising from market increases in the value of the above IRAs and self-employed pension plans. It appears the concept is: if the contributions are not exempt from creditors under the above rules, then a pro rata portion of the earnings should also not be exempt. The amount of exempt earnings is determined by multiplying the historical earnings by a ratio. The numerator of the ratio is the total amount of exempt contributions. The denominator is the total amount of all contributions (exempt and non-exempt).

Also, be aware that the IRA accountholder (i.e. the debtor) must claim the exemption. He or she will need to retain the proper records and show the proper calculations to support the amount being claimed as exempt. That is, the starting point is that the amount in an IRA is available to creditors and then it is up to the IRA accountholder to prove the amount which qualifies to be exempted.

Assets within a Roth IRA or Roth IRA annuity are exempt from creditors subject to the following special (and complicated) limits. As with traditional IRAs, there is a contribution limit and an earnings limit. The statute provides that assets under a Roth IRA or Roth IRA annuity are exempt, but only to the extent of the actual contribution amount or the maximum amount which federal law permits to be contributed. This provision is not clear. It may be the writers meant to say "the lesser of" but they did not say it. This means every Roth IRA accountholder is entitled to use the $2,000, $3,000 or $3,500 limits as applicable for the particular year.

The same formula is used to determine the special limit for the accumulated earnings or the market increases in the value of the Roth IRAs. The amount of exempt earnings is determined by multiplying the historical earnings by a ratio. The numerator of the ratio is the total amount of exempt contributions. The denominator is total amount of all contributions (exempt and non-exempt).

There appears to be another limit in subsection 627.6(f)(6) which must be applied to the contributions being made to a traditional IRA, traditional IRA annuity, SEP-IRA, SIMPLE-IRA, self-employed Keogh plan or a Roth IRA or Roth IRA annuity. For the two tax years preceding the claim for exemption or the filing of a bankruptcy, the maximum contribution is the maximum deductible contribution to a traditional IRA. The statute does not make clear whether this limit is applied to the specific individual or whether it applies in general. If it applies to a specific individual, the statute seems quite harsh because it penalizes those individuals who are "active participants" in a pension plan. Many active participants are not entitled to claim any tax deduction for an IRA contribution. A non-active participant is not affected by this special limit.

If assets are exempt within an IRA, IRA annuity, Roth IRA or Roth IRA annuity, then they retain their exempt status regardless of the number of times transferred.

Summary. Iowa exemption law is quite complicated. It should be clarified and simplified. All funds within IRAs, Roth IRAs, SEP-IRAs, SIMPLE-IRAs, and self-employed Keogh plans are NOT entitled to be exempted from creditors. Only certain limited amounts are entitled to be exempted. In fact, SEP-IRA and SIMPLE-IRA contributions in excess of the standard IRA

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limits are not entitled to be exempted. and are available to creditors. The same appears to be true of self-employed Keogh contributions. Keogh contributions are also available to creditors to the extent they exceed the standard IRA contribution limits. Note that there appears to be no exemption for IRA, Roth IRA, SEP-IRA, SIMPLE-IRA and self-employed Keogh funds when the funds are paid to the accountholder, unlike with certain pension funds. The accountholder of the IRA, Roth IRA, SEP-IRA, SIMPLE-IRA and the self-employed Keogh must claim and prove the exemption amount.

ADP Testing Corrections

As explained in the March 2004 issue of *The Pension Digest*, 401(k) plans must satisfy a number of tests in order to retain their status as a qualified plan. In the article, an example was provided demonstrating the application of the Actual Deferral Percentage (ADP) test. In that example, the ABC Manufacturing 401(k) plan passed the ADP test, and no further action was required.

Unfortunately, sometimes the ADP test fails. This is a result of the highly-compensated employees (HCEs) making elective deferrals at substantially higher rates than the non-highly compensated employees (NHCEs).

The illustration below is identical to the one shown in the March newsletter, except in this example, Jane Smith now shows deferrals of $2,500 instead of $625. As a result, the plan fails the ADP Test.

Employee	Compensation	Elective Deferral	ADR
Richard Anderson	$70,000	$7,000	10.00%
John Smith	$70,000	$3,500	5.00%
Jane Smith	$25,000	$2,500	10.00%
Total			25.00%
HCEs' ADP	(17.50% divided by 3)		**8.33%**

Employee	Compensation	Elective Deferral	ADR
Andy Carlson	$60,000	$4,350	7.25%
Ruth Garnett	$50,000	$4,500	9.00%
Steve Michaels	$35,000	$0	0.00%
Ann Washington	$20,000	$600	3.00%
Total			19.25%
NHCEs' ADP	(19.25% divided by 4)		**4.81%**

As noted, the NHCEs' ADP is 4.81%, limiting the HCEs' ADP to 4.81% plus 2%, for a maximum of 6.81%. ABC Manufacturing's 401(k) Plan fails the ADP test, since the HCE's ADP is 8.33%, when the law limits it to 6.81%.

What can the employer do when the ADP test fails?

An employer will either reduce the ADP for the HCEs or increase the ADP for the NHCEs. There are three methods available to accomplish this correction.

1. Excess contributions and allocable income are distributed. Under this method, the excess contributions (and income) must be returned to the appropriate HCE(s) within 12 months after the close of the plan year in which the excess contributions arose.

2. Excess contributions are recharacterized. As an alternative to making a corrective distribution, a plan may recharacterize the excess contributions as after-tax contributions. The recharacterized amount is treated as if it were received by the employee during the plan year and contributed to the plan on an after-tax basis. Accordingly, excess contributions that are recharacterized are includable in the employee's income on the earliest date any elective deferral would have been paid to the employee had the employee elected to receive the amounts in cash. The recharacterization must occur within 2½ months after the close of the plan year in which the excess contribution occurred. Since most employer plans do not allow for after-tax contributions, this solution is usually not available.

3. The use of QNECs (Qualified Nonelective Contributions) and QMACs (Qualified Matching Contributions). The employer may make contributions to the NHCEs in the amount necessary to increase the ADP of the NHCEs to the extent necessary to satisfy the ADP test. Since these additional contributions are treated as elective deferrals for ADP purposes, the plan will now pass the test. These contributions are nonforfeitable and subject to special distribution requirements. Because this solution requires an employer to make a contribution or an additional contribution, it is not used as often as the corrective distribution method.

How is the amount of excess contributions determined?

The excess contribution for an HCE for a plan year is the amount by which an HCE's elective deferrals must be reduced in order for the employee's actual deferral ratio (ADR) to equal the highest deferral ratio permitted under the ADP test. The determination of the excess contribution is a two-step process and can result in a lengthy calculation that is beyond the scope of this article. However, it should be noted that the elective deferrals of the HCE who has deferred the greatest dollar amount would be reduced before contributions made by other HCEs are reduced.

In the example above, the maximum ADR permitted is 7.71%. Thus, if Richard Anderson and Jane Smith's ADR is reduced from 10.00% to 7.71% respectively, the sum of the HCEs' ADR equals 20.42% (7.71% + 5.00% + 7.71%). The HCEs' ADP now equals 6.81% (20.42% divided by 3) and passes the ADP test. As a result, $2,175 must be distributed to correct the ADP failure. Since Richard Anderson deferred the greatest dollar amount, $2,175 plus the allocable income would be returned to him.

Does the employer need employee or the employee's spouse's consent before distributing the excess contributions?

No. The consent of an employee, or the employee's spouse, is not required before a corrective distribution of excess

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**ADP Testing Corrections,
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contributions and allocable income may be made pursuant to the terms of the plan. Furthermore, no consent is required with respect to recharacterization of excess contributions or utilization of QNECs and QMACs.

What are the timing, reporting and withholding rules that apply to correcting excess contributions?

➢ *Timing of corrective distributions.* If the corrective distribution(s) is made within the first 2½ months (March 15 for calendar year plans), the employer will avoid the 10% excise tax imposed under Code 4979, and the filing of Form 5330 (Return of Excise Taxes Related to Employee Benefit Plans). A corrective distribution made within the 2½ month period will generally be includable in the employee's income for the year in which the contributions were made.

A corrective distribution of excess contributions (and income) that is made outside of the 2½ month period is includable in the employee's gross income for the year in which the distribution occurred. As mentioned above, the employer is subject to a 10% excise tax on the excess contributions.

Depending on the particular circumstances, consideration should be given to the relative burden on the participant (who may have to file an amended return if payment is made within the 2½ month period) and the employer (who may have a modest excise tax obligation if the distribution is delayed).

➢ *Reporting corrective distributions.* Corrective distributions of excess contributions are reported on Form 1099-R. The gross distribution is reported in Box 1. If the corrective distribution is made within 2½ months after the close of the plan year, Distribution Code "P" or "D" (depending on the plan year) is reported in Box 7. If the corrective distribution is made more than 2½ months after the close of the plan year, Distribution Code "8" is reported in Box 7.

➢ *Federal income tax withholding.* Corrective distributions of excess contributions that are made within 2½ months after the end of the plan year are not subject to Federal income tax withholding or Social Security or Medicare taxes. However, corrective distributions that are made more than 2½ months after the end of the plan year are subject to Federal income tax withholding.

What other special rules need to be understood and applied when correcting excess contributions?

➢ *Corrective distributions treated as employer contributions.* Excess contributions are treated as employer contributions for purposes of the employer deduction rules of Code Section 404 and the annual addition limits of Code Section 415, even if the amounts are distributed from the plan.

➢ *Corrective distribution may not reduce minimum required distribution.* A corrective distribution of excess contributions and allocable income is not treated as satisfying an employee's minimum required distribution under Code Section 401(a) (9).

➢ *De minimis distributions.* If the amount of excess contributions distributed to a recipient for any plan year is less than $100 (without regard to attributable income), a corrective distribution of excess contributions and income will be includable in the employee's gross income in the tax year in which the distribution is made.

As you can see, a failed ADP test can result in frustration for HCEs and additional reporting and costs for the employer. As a result, it is advisable for employers to monitor the level of deferrals throughout the year or perform mid-year testing to ensure satisfaction of the ADP test. Another alternative for the employer is to adopt a safe harbor plan as discussed in a prior newsletter.

Q&A—SIMPLE-IRA Rules

Q: An employer just went over 100 employees in January 2004—what are their options?

A: An employer may maintain a SIMPLE plan structured as an IRA if it employed no more than 100 employees who received at least $5,000 in compensation from the employer for the preceding calendar year. For purposes of the 100-employee limitation, all employees employed at any time during the calendar year by the employer are taken into account, regardless of whether they are eligible to participate in the SIMPLE plan.

However, there is a two-year grace period. Employers who maintain a SIMPLE plan for at least one year, but who fail to be eligible in subsequent years, will be treated as meeting the 100-employee rule and, thus, may continue to maintain the plan for the two calendar years following the last year in which the employer satisfied the 100-employee rule. In other words, an employer exceeding the 100-employee threshold for the first time in 2004 may continue operating the plan through 2005.

Q: An employer is now looking at terminating the SIMPLE-IRA Plan and setting up a 401(k) plan – can the SIMPLE-IRA plan be terminated mid-year?

A: An employer generally cannot make contributions to a SIMPLE plan for any year in which the employer also maintains a qualified plan under which any of its employees accrues a benefit or receives an allocation of contributions. Since contributions have been made to the plan in 2004, Collin W. Fritz and Associates (CWF) recommends continued operation of the SIMPLE through 2004. The SIMPLE can be terminated at the end of 2004, and the employer can establish a 401(k) plan effective January 1, 2005.

Q: What would be the procedure to terminate?

A: There is no official notification required prior to terminating a SIMPLE-IRA plan. However, CWF recommends notifying employees of the employer's intent to establish a 401(k) plan effective January 1, 2005. This notification should be provided before November 1, 2004, allowing employees sufficient time to evaluate their options.

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Q&A—SIMPLE-IRA Rules, Continued from page 6

Q: Can the SIMPLE-IRA funds be rolled over to the 401(k) plan?

A: To qualify as a tax-free rollover, the employee must have at least two years of participation. The 2-year period begins on the date the first contribution was made into the SIMPLE-IRA.

Employees not satisfying the 2-year rule outlined above are subject to an early distribution tax of 25%. As a result, these employees should keep the assets in the SIMPLE-IRA until they meet the 2-year requirement. After satisfying the 2-year requirement, they can roll over the monies to the 401(k) plan or transfer the assets to a traditional IRA.

Creditors and Pension Assets

The United States Supreme Court recently issued its holding in the case of Raymond B. Yates, M.D. P.C. Profit Sharing Plan et al v. Hendon, Trustee. The court held that an owner of a business which has a plan covering one or more employees other than the business owner and his or her spouse, may qualify as other employees to participate in a qualified plan on equal terms with the other participants. Such owner qualifies for the protections ERISA affords all participants.

ERISA has an anti-alienation provision which states, "no benefit or interest available hereunder will be subject to assignment or alienation."

A bankruptcy trustee (Hendon) was seeking to collect funds within the profit sharing plan to be used to pay the creditors. The Sixth Circuit Court of Appeals had previously ruled that an owner does not ever qualify as a participant under ERISA since the owner is not an "employee." The U.S. Supreme Court did not accept their rationale.

We understand that the U.S. Supreme Court will next year rule on whether an owner with no other employees can ever qualify as a participant for ERISA purposes and whether or not a participant of a SEP-IRA or SIMPLE-IRA plan can ever qualify as a participant.

It will be very interesting to see how the case concerned with SEP-IRAs and SIMPLE-IRAs will be decided. A literal reading of ERISA clearly provides protection from creditors to those participants of a multiple SEP-IRA or SIMPLE-IRA plan. Nevertheless, the various Circuit Courts of Appeal have adopted a very simplistic approach and ruled that SEP-IRAs and SIMPLE-IRAs need not be treated any differently than traditional IRAs. Therefore, such courts have allowed creditors to reach the assets within SEP-IRAs and SIMPLE-IRAs. Under the law, there are clear differences between traditional IRAs and SEP-IRAs and SIMPLE-IRAs. In CWF's opinion, the appellate courts have been wrong when they have ignored the differences.

IRS Reporting Is Required for a Revoked IRA

When a contribution to an IRA is revoked within the allowed 7-day period, the contribution is still reported on Form 5498, and the distribution is reported on Form 1099-R.

The IRS 2004 1099-R Instructions read as follows:

"If a traditional or Roth IRA is revoked during its first 7 days (under Regulations section 1.408-6(d)(4)(ii)), the distribution from the IRA must be reported. In addition, Form 5498, IRA Contribution Information, must be filed to report any regular, rollover, Roth IRA Conversion, SEP-IRA or SIMPLE-IRA contribution to an IRA that is revoked.

If a **regular contribution** is made to a traditional or Roth IRA that later is revoked, and distribution is made to the taxpayer, enter the gross distribution in box 1. If no earnings are distributed, enter 0 (zero) in box 2a and Code 8 in box 7 for a traditional IRA and Code 8 with Code J* for a Roth IRA. If earnings are distributed, enter the amount of earnings in box 2a. For a traditional IRA, enter Code 1 in box 7; for a Roth IRA, enter Code J. These earnings could be subject to the 10% early distribution tax under section 72(t). If a **rollover contribution** is made to a traditional or Roth IRA that later is revoked, and distribution is made to the taxpayer, enter in boxes 1 and 2a of Form 1099-R the gross distribution and the appropriate code in box 7 (Code J for a Roth IRA). Follow this same procedure for a transfer from a traditional or Roth IRA to another IRA of the same type that later is revoked. The distribution could be subject to the 10% early distribution tax under section 72(t).

If an IRA **conversion contribution** is made to a Roth IRA that later is revoked, and distribution is made to the taxpayer, enter the gross distribution in box 1 of Form 1099-R. If no earnings are distributed, enter 0 (zero) in box 2a and Code J in box 7. If earnings are distributed, enter the amount of the earnings in box 2a and Code J in box 7. Theses earnings could be subject to the 10% early distribution tax under section 72(t).

If an employer SEP (simplified employee pension) IRA or SIMPLE (savings incentive match plan for employees) IRA plan contribution is made and the SEP-IRA or SIMPLE-IRA is revoked by the employee, report the distribution as fully taxable.

For more information on IRAs that have been revoked, see Rev. Proc. 91-70, 1991-2 C.B. 899

***Note:** Code J is used for a distribution from a Roth IRA when you do not know if the participant is under age 59 1/2, and there are no known exceptions. For example, you may not know whether an exception under section 72(t) applies (such as medical expenses, first-time home buyer, etc.) or whether the distribution is a qualified distribution because the taxpayer qualifies as a first-time homebuyer under section 408A(d)(2).

Summary: It is important to remember that when an IRA is revoked, the contribution and ensuing distribution are reportable events. It is also important to prepare the required governmental reporting correctly.

Furnishing a SIMPLE-IRA Checklist to Your SIMPLE-IRA Customers

The IRS has prepared a checklist to help employers and their advisers administer their SIMPLE-IRA plans. An IRA custodian should consider furnishing it to your SIMPLE-IRA clients as a customer service.

SIMPLE IRA PLAN CHECKLIST

This Checklist is *not* a complete description of all plan requirements, and should *not* be used as a substitute for a complete plan review.

For Business Owner's Use

(DO NOT SEND THIS WORKSHEET TO THE IRS)

Every year it is important that you review the requirements for operating your Savings Incentive Match Plan for Employees of Small Employers (SIMPLE) IRA plan. This Checklist is a "quick tool" to help you keep your plan in compliance with many of the important tax rules. Underlined text below will link you to Internet information.

1. Does your business have 100 or fewer employees? Yes ☐ No ☐

Businesses with more than 100 employees (including full-time, part-time, and seasonal employees) with individual earnings of at least $5,000 yearly cannot establish a SIMPLE IRA plan.

2. Is this SIMPLE IRA plan your business's only retirement plan? Yes ☐ No ☐

A business with a SIMPLE IRA plan generally cannot also sponsor any other retirement plan, such as a 401(k) plan.

3. Do you know how to, and did you, identify your eligible employees? Yes ☐ No ☐

An eligible employee is one with compensation of at least $5,000 per year in any 2 prior years, who is expected to earn at least $5,000 this year.

4. Is the business that the SIMPLE IRA plan covers the only business that you and/or your family members own? Yes ☐ No ☐

Employees of other businesses you and/or your family members own may have to be considered when determining who is an eligible employee under this SIMPLE IRA plan.

5. Did you notify your eligible employees of their right to elect salary reduction or modify a prior salary reduction agreement? Yes ☐ No ☐

Each year, you must give your employees notice before November 2 of their right to participate in the retirement plan for the next year and to change a prior salary reduction agreement.

6. Do you give your employees an annual notice, before November 2 of each year, of plan provisions and employer contribution levels for the upcoming year? Yes ☐ No ☐

You must give your employees notice of the plan provisions and employer contribution levels, including any plan changes, at least 60 days prior to the start of the next calendar year.

7. Have you allowed employees to terminate their salary reduction election? Yes ☐ No ☐

You must allow your employees, *at any time,* to stop making deferrals.

8. Have you deposited employee deferrals timely? Yes ☐ No ☐

You must deposit an employee's deferral in the IRA as soon as possible, but no later than 30 days following the month in which the employee would have otherwise received the money.

9. Have you deposited employer contributions timely? Yes ☐ No ☐

As an employer, you have until the due date, including extensions, of your tax return to deposit matching contributions or nonelective contributions.

10. Are employee deferrals to SIMPLE IRAs limited as required by law? Yes ☐ No ☐

The deferral limit to a SIMPLE IRA is $8,000 for 2003, $9,000 for 2004, and $10,000 for 2005. Catch-up contributions of participants, aged 50 or over, are limited to an additional $1,000 for 2003, $1,500 for 2004, and $2,000 for 2005.

If you answered "No" to any of the above questions, you may have a mistake in the operation of your SIMPLE IRA plan. Many mistakes can be corrected easily, without penalty and without notifying the IRS.

- **contact your benefits professional**
- **visit the IRS at www.irs.gov/ep**
- **call the IRS at (877) 829-5500**