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THE Pension Digest

ALSO IN THIS ISSUE –

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

9898 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code	1 Gross distribution $ 2a Taxable amount $	OMB No. 1545-0119 2004 Form 1099-R	Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.
	2b Taxable amount not determined ☐	Total distribution ☐	Copy A For Internal Revenue Service Center
PAYER'S Federal identification number / RECIPIENT'S identification number	3 Capital gain (included in box 2a) $	4 Federal income tax withheld $	File with Form 1096.
RECIPIENT'S name	5 Employee contributions or insurance premiums $	6 Net unrealized appreciation in employer's securities $	For Privacy Act and Paperwork Reduction Act Notice, see the 2004 General Instructions for Forms 1099, 1098, 5498, and W-2G.
Street address (including apt. no.)	7 Distribution code(s) / IRA/ SEP/ SIMPLE ☐	8 Other $ %	
City, state, and ZIP code	9a Your percentage of total distribution %	9b Total employee contributions $	
Account number (optional)	10 State tax withheld $ $	11 State/Payer's state no.	12 State distribution $ $
	13 Local tax withheld $ $	14 Name of locality	15 Local distribution $ $

Form 1099-R Cat. No. 14436Q Department of the Treasury - Internal Revenue Service

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IRS Issues 2004 1099-R Instructions

The 2004 1099-R Instructions were recently issued by the IRS. A major change has been made concerning the reason code to be used to report substantially equal periodic payments. In the past, the 1099-R instructions have specifically noted that the code used to report substantially equal periodic payments is Code 2. However, the new 2004 instructions no longer list "substantially equal periodic payments" as a reason to use Code 2, thereby effectively changing the code for substantially equal periodic payments to now be Code 1. CWF will be revising Form #57 to reflect this change. Institutions may certainly still use existing inventory of this form, as it is still accurate for all distributions other than substantially equal periodic payments; however, if the existing form is used to denote substantially equal period payments, the institution will have to remember that the reason code is now Code 1 and not Code 2, as listed on the existing form. CWF has the new #57 available for purchase.

Illustration—The Importance of the Correct Distribution Code

It is extremely important that the correct code is used when funds are distributed from an IRA. The following is an example of the consequences that can result when an incorrect code is used.

Situation: An individual, age 68, withdraws $75,000 from his Roth IRA in 2002. This individual had converted his traditional IRA of $300,000 to a Roth IRA in 1999. The bank prepared the 2002 Form 1099-R as follows — $75,000 in box 1, box 2a was left blank, and Code 7 was listed in box 7. The IRA/SEP/ SIMPLE checkbox was **not** checked.

Boxes 1 and 2a were prepared correctly, as was the checkbox in box 7. The reason code was incorrect; it should have been "T." The IRS instructions state that Code 7 is to be used for (1) a normal distribution from a plan, including a traditional IRA, if the employee/taxpayer is at least 59½, (2) for a Roth IRA conversion or

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The Importance of the Correct Distribution Code, Continued from page 1

reconversion if the participant is at least age 59½, and (3) to report a distribution from a life insurance, annuity, or endowment contract. DO NOT use Code 7 for a Roth IRA distribution.

The Problem: Because the distribution was coded as a normal IRA distribution, the IRS wrote the individual stating he owed $22,000 more in income tax. Because it was actually a distribution from the individual's Roth IRA, the individual, correctly, did not report this income as taxable on his tax return.

The Solution: The bank will need to prepare a corrected 1099-R showing that the distribution was from a Roth IRA and not a traditional IRA. Code T is the reason code to use for this corrected 1099-R. Code T is used for a Roth IRA distribution when the accountholder is age 59½ or older and you do not know whether or not the 5-year holding period has been met. Code T would also be used for a distribution from a Roth if the participant had died or become disabled, and you do not know whether or not the 5-year holding period has been met.

The use of an incorrect code can cause tax difficulties for an accountholder. An institution needs to be aware from which type of IRA a distribution is being taken, and be certain to use the correct code. As illustrated, the bank may have to do additional work to rectify the situation, and, could possibly have some liability if the accountholder is assessed penalties or interest by the IRS because of the bank's error.

"Relatively" New Benefits of Qualified Plans

With the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) came sweeping provisions affecting the administration and operation of employer-sponsored retirement plans. In this article, we will discuss a couple of the changes and how we believe they enhance the overall attractiveness of qualified plans for employers, employees, and financial institutions servicing such employers.

Amongst those changes were rules regarding plan loans and rollovers. The Tax Act eliminated the restrictions on plan loans to owner-employees who sponsor a qualified retirement plan. Accordingly, sole proprietors, partners in a partnership or limited liability corporation (LLC), and shareholder-employees of subchapter S corporations may receive plan loans under the same rules as all other plan participants. However, the law prohibiting plan loans from an IRA (including SEP IRAs and SIMPLE IRAs) remained unchanged.

Pursuant to the Tax Act, many of the restrictions on rollovers between plans have been relaxed. Eligible rollover distributions from qualified retirement plans, 403(b) annuities, governmental 457 plans and IRAs may now be rolled over to any such plans or arrangements that accept the rollovers. Accordingly, the requirement to roll over to a similar plan or arrangement is no longer applicable. Previously, the only IRA account balances that could be rolled over to a qualified retirement plan were conduit IRA amounts (i.e., amounts maintained in a qualified plan and then rolled over to an IRA designed to hold only qualified plan distributions).

As noted above, an IRA accountholder can now roll over the IRA balance into an employer-sponsored retirement plan if the plan authorizes the contribution of such rollovers. This in turn permits the plan participant to take a loan from these monies, as the amount of IRA funds rolled over to the qualified plan is taken into account when determining the maximum amount available for a plan loan. This means that an owner or a plan participant now has access to money they otherwise would not have, since one can never borrow monies from his or her IRA. Generally, a participant can borrow up to 50% of their account balance, up to a maximum loan of $50,000. A participant who rolled over $40,000 from their IRA to an employer-sponsored retirement plan could take a loan up to $20,000 with respect to these monies. A plan loan must usually be paid in full within five years, unless the loan is used to acquire a principal residence of the participant. Loan payments are usually paid monthly or quarterly. By taking a plan loan instead of a distribution, the participant avoids the early distribution tax (assuming below age 59½) and personal income tax. Furthermore, since the monies are required to be repaid to the plan, it allows the participant to accumulate monies in a tax-deferred account.

In addition, funds within a qualified retirement plan with more than one participant receive extensive protection from creditors, whereas assets within IRAs (including SEP IRAs and SIMPLE IRAs) do not.

Custodial Procedures for an Inherited IRA

An inherited IRA comes into existence when the IRA accountholder dies. In the legal sense, there is nothing which the beneficiary or the IRA custodian must do to create the inherited IRA. An IRA custodian does have special administrative concerns with respect to an inherited IRA. The tax laws, and the IRA plan agreement, require that a beneficiary be paid the applicable required distributions. Certain governmental reporting forms must be prepared by the IRA custodian. There needs to be a final Form 5498 for the decedent. Each beneficiary will need to be furnished a Form 5498 reflecting the fair market value as of any December 31st of their portion of the inherited IRA. A Form 1099-R must be furnished to each beneficiary who is paid funds from the inherited IRA.

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Custodial Procedures for an Inherited IRA, Continued from page 2

The question becomes, will the IRA custodian's software allow it to administer the inherited IRA(s) by leaving the account in the name of the decedent or will such administration be more easily performed if the funds are transferred from the decedent's IRA to one of more inherited IRAs established for each beneficiary?

Each institution needs to answer this question for itself. There is no IRS requirement that an IRA custodian set up an inherited IRA for a beneficiary. There may well be IRA software which is sufficiently well written so that once the accountholder dies, the software will be able to prepare the proper governmental reporting forms for both the deceased accountholder and each beneficiary based on that one computer file. We believe the existence of such software is rare. Most IRA custodians will find it desirable to transfer the funds from the decedent's IRA into one or more inherited IRAs as set up for each beneficiary, because it simplifies the performing of the administrative tasks.

Many people think the IRS must want to be informed that the beneficiary(ies) has inherited these IRA funds. The IRS does not. The fact is, under current IRS procedures, the IRS does not require an IRA custodian, the tax preparer for the decedent, or the IRA beneficiary to inform the IRS that the beneficiary has inherited IRA funds. The IRS' current procedure is, when a distribution is actually made to a beneficiary, then the IRA custodian must prepare a Form 1099-R reporting the distribution. The beneficiary will generally be required to include the total distribution in his or her income and pay the appropriate income tax.

Surprising or not, the movement of the funds from the decedent's IRA to an inherited IRA is a special transfer and is not reportable to the IRS. A Form 1099-R will not be prepared for these transfers. A Form 1099-R, however, will be required to be prepared for an actual distribution from the inherited IRA to the beneficiary. A reason code "4/death" is to be used for such distribution.

What Is the Difference Between an IRA Conversion and a Recharacterization?

There seems to be much confusion concerning IRA conversions and IRA recharacterizations. It seems these terms are used interchangeably throughout the financial industry, when, in fact, they are actually very different events. In the discussion below, we hope to clarify the differences.

Definitions

An IRA conversion contribution is made when funds are distributed from a traditional IRA and put into a Roth IRA for the purpose of receiving the benefit of tax-free distributions (interest and principal) from the Roth IRA. Note that a person <u>cannot</u> convert funds in his or her Roth IRA to a traditional IRA.

A recharacterization occurs when the IRA accountholder instructs that he or she wishes to change the type of contribution he or she made. Example #1: Jane Doe made a $3,000 contribution to her traditional IRA and she now decides she wants that contribution to have been made to her Roth IRA. Example #2, John Doe made a $3,500 contribution to his Roth IRA and he now decides he wants that contribution to have been made to his traditional IRA. Example #3, Mary Doe made a conversion contribution of $40,000 to her Roth IRA from her traditional IRA. She wins the lottery and becomes ineligible to make such conversion contribution. She is allowed to return the funds in her Roth IRA to her traditional IRA.

Purposes

A person converts some or all of his traditional IRA to a Roth IRA with the intent that some day all the earnings of the Roth IRA will be tax free. The person is willing to pay federal income taxes now so that he will be able to earn tax-free income later.

A person recharacterizes a contribution because he or she wants to change the type of contribution he or she made. Most often a person has made an excess contribution or an ineligible conversion and can correct the situation by recharacterizing it.

Tax Impact

As discussed above, a person who converts from his traditional IRA to his Roth IRA will be required to include such distribution in his income and pay the appropriate taxes.

A taxable event does <u>not</u> occur when a person recharacterizes a contribution from being a traditional IRA to a Roth IRA or vice versa. The concept of the law is that the person is treated as if he or she had made the original contribution to the "second" IRA. Although the event is not taxable, it is reportable.

Governmental Reporting

A conversion of traditional IRA funds to a Roth IRA must be reported to the IRA accountholder and to the IRS. A Form 1099-R is prepared to show the amount being distributed from the traditional IRA. The reason code to be used is a "2" (premature distribution, but an exception known) or a "7" (age $59^1/_2$ or older). A Form 5498 is prepared to show a conversion contribution was made into the Roth IRA. This is done by completing box 3 of the 2003 Form 5498.

There must also be reporting with respect to the recharacterization of a distribution. A Form 1099-R must be prepared to show the amount being withdrawn from the first IRA to which the funds were actually contributed. The IRS has special reason codes—an "N" or an "R." A Form 5498 (box 4) must be prepared to show the amount being moved to the "second" IRA.

Questions Regarding Rolling Over After-Tax Contributions

Situation. We (ABC Bank) received a direct rollover check in the amount of $1,800. The check was issued by the Iowa Public Employees Retirement System (IPERS). The check was payable to ABC Bank, IRA custodian for Jane Doe's IRA. Jane Doe has now informed your bank that IPERS had furnished her a Notice (a section 402(f) notice) explaining her distribution and direct rollover options. Her vested account balance was $1,800. Of this amount, $500 was after-tax employee contributions. She supposedly asked the IPERS representative what she should do with the $500. The IPERS representative told her that she could not give her tax advice and that she would need to review the section 402(f) notice and consult with her tax advisor. Somewhat frustrated, Jane decided she would directly roll over the entire $1,800 and decide later what to do with the $500 of after-tax contributions. The funds are now within her IRA with ABC Bank. Jane now wants to understand what her options are. Most likely, she wants to take a distribution of the $500 and have it all be nontaxable.

Question #1. Is Jane permitted to take out, on a first-out basis, the after-tax amount of $500?

Answer #1. No. The federal income tax law requires the use of a pro-rata distribution rule.

Question #2. Will Jane be required to report the fact that she rolled over after-tax contributions to her IRA?

Answer #2. Yes. She will want to review the instructions for Form 8606. She will be required to report her after-tax contributions on such form.

Question #3. Could she have instructed IPERS to directly roll over $1,300 and to distribute the amount of $500 to her?

Answer #3. Yes. The law states that the last dollars distributed from a pension plan are considered to be the after-tax dollars. The time to decide what to do with after-tax employee contributions is when the money is still in the employer's retirement plan and not when it is in the IRA. It is generally too late once the retirement account balance has been directly rolled over into an IRA. An IRA custodian can perform a valuable customer service by reminding its direct rollover customers of this fact.

Proposed IRA Legislation

Possible Penalty-Free IRA/Pension Plan Withdrawals for Reservists and Guardsmen

A bill has been introduced in the Senate (S. 2375) which would allow military reservists and National Guardsmen to make penalty-free withdrawals from their IRA and retirement plans while they are on active duty. A similar measure was passed by the House on April 21, 2004.

In most instances, distributions from an IRA or pension plan prior to the accountholder attaining age 59½ are subject to a 10% penalty on the taxable portion of the distribution. This 10% penalty is in addition to any regular income tax the accountholder would owe on the distribution.

The Guardsmen and Reservists Financial Relief Bill of 2004 (S. 2375) was introduced in the Senate on May 3, 2004, by Senator Orrin Hatch (R-UT), a member of the Senate Finance Committee. This bill would amend Code section 72(t)(2) to provide an exception to the early distribution penalty tax for "qualified reservist" distributions. Such distributions would include distributions from: (1) an IRA, and (2) a 401(k) plan, 403(b) plan, or any other specified retirement plan. The distribution must be made to a military reservist or National Guardsman who has been ordered or called to active duty for a period of at least 179 days. The period of 179 active duty days must occur after September 11, 2001, and prior to September 12, 2005.

This bill would also allow individuals who have taken a qualified reservists distribution to repay the amount withdrawn. The amount must be repaid within the two-year period following the end of the individual's active duty. Such repayment would not be subject to the contribution limit rules to the extent that the contribution is the repayment of the qualified reservist's distribution. The repayment contributions CANNOT be deducted on the individual's tax return.

IRA Test

Set forth below are 28 questions to test your IRA knowledge. Best of luck. Be careful, because, as with all tests, there are some "trick" questions. There are eleven true/false questions (1-11), and seventeen multiple choice questions. These questions come from the 2003 test for enrolled tax agents. The IRS tends to use the tax laws applying to the year prior to the year the test is given. Thus, many of the questions deal with tax year 2002. The answers are given on page 6 along with some additional comments for each question.

1. Generally, an eligible taxpayer, 50 years of age or older, may make both of the following in tax year 2002; A $3,500 contribution to a traditional IRA, and a $3,500 contribution to a Roth IRA.

☐ True ☐ False

2. Excess contributions to IRA's for tax year 2002 are not subject to a penalty if both the excess contribution and earnings are withdrawn before December 31, 2003.

☐ True ☐ False

3. An early distribution from an IRA, caused by an IRS levy of the qualified plan, is subject to the early distribution penalty.

☐ True ☐ False

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4. Jeff, age 30, began participating in a SIMPLE retirement account on January 1, 2001. He took an early distribution from the account on December 1, 2002. He is subject to a 10% penalty on the early distribution.
☐ True ☐ False

5. Generally, when a traditional IRA is involved in a prohibited transaction, it is treated as distributing its assets on the date of the transaction.
☐ True ☐ False

6. Generally, when a traditional IRA is involved in a prohibited transaction, it is treated as distributing its assets at fair market value on the first day of the year.
☐ True ☐ False

7. If you receive a distribution from your employer's qualified plan of any part of the balance of your DEC (voluntary deductible employee contributions) and the earnings from them, you may roll over any part of the distribution.
☐ True ☐ False

8. Debra, age 30, had established a traditional IRA at her local bank several years earlier. In September, Debra told the custodian to use the amount in her account to buy an annuity contract. The bank sent the annuity contract to her in October. Debra will be taxed on the annuity contract in 2002.
☐ True ☐ False

9. Income passed through to a limited partner is treated as compensation for purposes of determining an allowed IRA contribution.
☐ True ☐ False

10. Distributions from a Roth IRA must begin no later than April 1 of the year following the year the account owner reaches age $70^1/_2$.
☐ True ☐ False

11. Generally, for tax year 2002, up to $2,000 per year may be contributed to a Coverdell education saving account.
☐ True ☐ False

12. Alice and Mike file a joint return for 2002, on April 15, 2003. Alice, who is a nonworking spouse, is age 49. Both Alice and Mike contributed $2,000 each to a traditional IRA although they qualified to contribute the maximum amount. They filed their return timely. On June 1, 2003, Mike's mother gave each of them $1,000. What additional amount of the gift may Alice and Mike contribute to each of their IRA's for the year 2002?
☐ A. 0 ☐ B. $1,000 ☐ C. $500 ☐ D. $3,000

13. The use of IRA funds in prohibited transactions can result in additional taxes and penalties. Which of the following is not a prohibited transaction in a traditional IRA?
☐ A. Borrowing money from the IRA.
☐ B. Selling property to an IRA.
☐ C. Inheriting your spouse's IRA.
☐ D. Using an IRA as security for a loan.

14. Generally, which of the following is a prohibited transaction concerning your traditional IRA?
☐ A. Withdraw funds for qualified higher education expenses.
☐ B. Pledge your IRA account as security for your mortgage.
☐ C. Withdraw funds for qualified medical expenses.
☐ D. Withdraw funds to purchase your first home.

15. Max, a fiduciary, pledged his client's traditional IRA of $300,000 as security for a loan. If Max is found liable for engaging in a prohibited transaction, what is the minimum penalty he is most likely to pay if the transaction is not corrected?
☐ A. $45,000 ☐ B. $30,000 ☐ C. $36,000
☐ D. $300,000

16. The SIMPLE 401(k) plan is a qualified retirement plan. The SIMPLE is not subject to nondiscrimination and top-heavy rules if the plan meets all of the conditions except:
☐ A. Under the plan, the employees may choose salary reduction contributions to a trust up to $7,000 for 2002.
☐ B. Participants age 50 and over can make a catch-up contribution up to $500.
☐ C. Employers must make matching contributions of 3% of compensation for the year or nonelective contributions of 2% of compensation on behalf of each eligible employee who has at least $5,000 of compensation from his employer for the year.
☐ D. The employee's rights to any contributions are forfeitable.

17. Joe (single, age 51) wants to defer the maximum amount possible to his 401(k) plan. What is the amount of basic and catch-up contributions he may make for tax year 2002?
☐ A. $11,000 ☐ B. $41,000 ☐ C. $25,000
☐ D. $12,000

18. Sam received a total distribution of $40,000 from his employer's 401(k) plan consisting of $25,000 in cash, and land with a fair market value of $15,000. If Sam decides to keep the land, what is the total amount that he can roll over to his IRA?
☐ A. Sam may substitute $15,000 of his own funds for the property and consider his rollover to be $40,000 in cash.
☐ B. Sam can roll over only $15,000 — the value of the land he received.
☐ C. Sam can roll over the $25,000 cash received into his IRA.
☐ D. Sam is required to sell the land before any part of the distribution can be rolled over.

19. The 2002 basic limit on elective deferrals in 401(k) plans (excluding SIMPLE plans) for participants under age 50 is:
☐ A. $7,000 ☐ B. $10,500 ☐ C. $11,000 ☐ D. $12,000

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IRA Test,
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20. In 2002, MaryAnn, a nonworking spouse, files a joint return with Jack, who is not covered by a pension plan at work. Their AGI is $50,000 and Jack plans to contribute $3,000 to a traditional IRA. MaryAnn, who is age 51, wishes to contribute to an IRA. What is the maximum amount she can contribute?

☐ A. $3,000 ☐ B. $2,000 ☐ C. $3,500 ☐ D. $2,500

21. Sally, age 38, converted $14,000 from her traditional IRA to a Roth IRA in 2002. When she had her tax return prepared for 2002, her tax professional informed her the conversion was not allowed, because her income was $300,000. If she does not do a recharacterization by April 15, 2003, what are her consequences?

☐ A. Pay tax and a 10% penalty on all of the $14,000 conversion, plus a 6% penalty on the full $14,000.
☐ B. Pay a 6% penalty only on the full $14,000
☐ C. Pay tax only on the full $14,000
☐ D. Pay tax and a 10% penalty on $14,000

22. Kimberly, age 30, a full-time student with no taxable compensation, married Michael, age 30, during 2002. For the year, Michael had taxable compensation of $35,000. He plans to contribute and deduct $3,000 to his traditional IRA. If he and Kimberly file a joint return, how much may each deduct in 2002 for contributions to their individual traditional IRAs, and what is the compensation Kimberly uses to figure her contribution limit?

	IRA Deduction	Compensation
☐ A.	$3,000	$32,000
☐ B.	$3,000	$35,000
☐ C.	$2,500	$35,000
☐ D.	$2,000	$32,500

23. To recharacterize the Roth IRA back to a traditional IRA, you must do the following:

☐ A. Withdraw the earnings as only the principal investment is eligible.
☐ B. A trustee-to-trustee transfer, including the income earned, if any.
☐ C. Request written permission for the IRS
☐ D. File Form 5329 to pay the penalty on the earnings.

24. Morris, a single taxpayer, is not covered by a qualified plan at his place of employment. He wishes to establish an IRA and contribute $3,000 for 2002. An IRA may be invested in all of the following accounts except:

☐ A. Bank CD. ☐ B. Mutual Fund ☐ C. Annuity.
☐ D. Artwork

25. John, a self-employed taxpayer, has a SEP plan for his business. He has three eligible employees, Sara (age 37), and Jean (age 45), who have worked for him for the past 10 years. For the year 2002, Sara earned $15,000, Joseph earned $25,000, and Jean earned $30,000. He wants to elect the 25% contribution rate so he can put as much as possible in for himself. If he elects 25%, how much must he contribute to the plan for his employees?

☐ A. 0 ☐ B. $2,100 ☐ C. $17,500 ☐ D. $40,000

26. Mike is self-employed. He is a calendar-year taxpayer. If he wants to set up a SEP plan for his business for 2002, he must do so by (including extensions):

☐ A. December 31, 2002 ☐ B. January 31, 2003
☐ C. April 15, 2003 ☐ D. October 15, 2003

27. Generally, an IRA contribution is limited to the lesser of $3,000 in 2002, or the taxpayer's compensation. However, which of the following items is not treated as compensation for this limitation?

☐ A. Wages earned by an individual under the age of 18
☐ B. Taxable alimony.
☐ C. Self-employment loss.
☐ D. Commissions.

28. John failed to take required minimum distributions from his traditional IRA. The excess accumulation is subject to a penalty of:

☐ A. 6% ☐ B. 10% ☐ C. 15% ☐ D. 50%

Quiz (Answers) and Explanation

1. **(F)** For purposes of the contribution limit, one is required to aggregate his or her Roth IRA contributions with his or her traditional IRA contributions.

2. **(F)** The deadline to correct excess contributions is October 15, 2003 (April 15, 2003, plus extensions).

3. **(F)** The law was changed so that the 10% tax would not apply to a distribution caused by an IRS levy.

4. **(F)** For distributions from SIMPLE-IRAs, the penalty tax is 25%, and not 10%, when the 2-year participant requirement has not been met.

5. **(F)** The IRA is considered distributed on the first day of the tax year when a prohibited transaction (PT) occurs, and not on the date the PT actually occurs.

6. **(T)** See #5.

7. **(T)** Commencing in 2002, the law authorizes rolling over after-tax employee contributions from an employer-sponsored plan into an IRA. A person is not required to roll over after-tax contributions, but he or she may, if they want.

8. **(F)** To CWF, this question was unclear. It was unclear whether or not what was being purchased was an IRA annuity. If an IRA annuity was purchased, then the transaction should result in no taxation, since it is the equivalent of a transfer. However, if it was a standard annuity (i.e. not an IRA annuity), then a distribution has occurred and she would be taxed.

9. **(F)** A general partner's income from a partnership qualifies as compensation for IRA purposes, but income paid to a limited partner does not.

10. **(F)** The April 1 deadline does not apply, since required distributions are not required for living Roth IRA accountholders.

11. **(T)** The contribution limit for Coverdell ESA contributions changed starting with 2002, from $500 per person to $2,000 per person.

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IRA Test,
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12. **(A)** The last day to make a contribution for tax year 2002 was April 15, 2003. Mike's mother did not make her gift until June 1, 2003. No portion of her gift may be used to increase their 2002 contributions.

13. **(C)** The inheriting of your deceased spouse's IRA is NOT a PT.

14. **(B)** The classic PT occurs when a person pledges his or her IRA as security for a loan or other debt. The other withdrawals are exceptions to the 10% penalty tax and are not PTs.

15. **(A/D)** The IRS accepts both A and D as the correct answer. If the IRA accountholder causes the PT, then the IRA is deemed distributed as of the first day of the year, and income tax must be paid, including the 10% additional tax, if applicable. This can cause very harsh tax consequences. If it is the IRA custodian or another fiduciary who causes or participated in the PT, then a different rule applies, since it would be unfair to impose "the include in income rule" on the accountholder if he or she did not cause the PT. Rather, the law imposes a 15% excise tax on the fiduciary ($300,000 x 15%) for its pledge. The law also imposes a 100% tax if the fiduciary, after being notified by the IRS, does not correct the PT in a timely fashion.

16. **(D)** The employee's right must be nonforfeitable and not forfeitable.

17. **(D)** The elective deferral limit for 2002 was $11,000 per person; in addition, an individual over age 50 could make a catch-up contribution of $1,000.

18. **(C)** A person may roll over cash and the property he or she receives in a distribution from a 401(k) plan. In this case, the person decided to keep the land. Thus, the person may only roll over the cash of $25,0000. The person cannot sell the property to himself or herself and roll over the proceeds.

19.**(C)** The 2002 basic limit for 401(k) elective deferrals was $11,000. The 2002 basic limit for SIMPLE IRA elective deferrals was $7,000.

20. **(C)** Even though Jack may only contribute $3,000, since he is under age 50, his wife's contribution limit is $3,500, since she is age 51. She would be making a spousal contribution, and she is permitted to do so, since Jack has sufficient compensation for both of their contributions.

21. **(A)** The question is not totally correct, since the deadline to correct recharacterizations for tax year 2002 is October 15, 2003, and not April 2003 (plus extension). But if Sally does not recharacterize her failed conversion of $14,000, then she does have the following adverse tax consequences: (1) the distribution of the $14,000 will be included in her income for 2002; (2) she will owe the 10% additional tax, or $1,400, since she, at age 38, is under age 59½; and (3) she will owe the 6% excise tax of $840, since the $14,000 is an excess contribution within the Roth IRA.

22. **(A)** This question is similar to question 20. As long as Kimberly and Michael are married as of 12/31/02, she is entitled to use the spousal IRA contribution rules. Kimberly is permitted to make an IRA contribution for herself to the extent of $3,000, as long as Michael has compensation remaining after he makes his own contribution. Since he earned $35,000 and he contributed $3,000 to his IRA, Kimberly may use the remaining $32,000 of his compensation to make her own IRA contribution. The fact that she is a full-time student does not disqualify her.

23. **(B)** The IRS did not write this question as well as it should have. The IRS indicated that "B" is the correct answer. "B" stated that, in order to recharacterize a Roth IRA back to a traditional IRA, a person must do a trustee-to-trustee transfer, including the income earned. There are more rules to be met than these. Technically, the taxpayer must inform the IRA custodian of the type and the amount of the contribution to the first IRA that is to be recharacterized, the date the original contribution was made, an instruction to transfer a certain amount of the original contribution plus the allocable income, and the names of the first and second IRA custodians. Answers A, C, and D were incorrect for the following reasons. Answer A stated that the earnings must be withdrawn when they must be recharacterized as well as the original contribution. Answer C was wrong because one does not need written permission from the IRS to do a recharacterization. Answer D was wrong because doing a recharacterization does not require a person to file the Form 5329 and pay any taxes.

24. **(D)** The law prohibits an IRA from investing in "collectibles." Artwork is a collectible. In general, most personal property is a collectible. There are some exceptions — gold, certain coins, stocks, bonds, etc.

25. **(C)** The general rule is that a SEP plan requires all participants to receive the same percentage of their compensation. Since the compensation of the employees was $70,000, and since the owner received a 25% contribution, then the owner is required to contribute $17,500 ($70,000 x 25%) to the other employees.

26. **(D)** The law permits a self-employed person to establish and fund his or her SEP plan by October 15, 2003, for 2002 tax purposes. The actual deadline is April 15, 2003, plus extensions.

27. **(C)** It is an old rule, but a person who is both an employee (assume wages of $30,000) and also self-employed (assume a loss of $35,000) is still allowed to make an IRA contribution, since he or she is not required to aggregate the wage income with the self-employment loss.

28. **(D)** Congress has considered a number of proposed law changes to reduce the 50% tax which is assessed for excess accumulations. I believe 10%, 15% and 20% have been proposed instead of the 50%. Congress has stayed with the 50%. In some situations, the IRS will waive the 50% assessment. IRS statistics, however, show the IRS is collecting larger amounts each year because individuals have failed to withdraw their required distributions.

IRA Distribution Codes

Special Note. CWF has created this special chart. The IRS has prepared its *Guide* to summarize all of the Distribution Codes to be used in completing a Form 1099-R. There are 22 different reason codes, since the Form 1099-R is used to report distributions from pension plans, 403(b)s, general annuities and IRAs. Seven of the 22 codes do not apply to IRAs. In an attempt to simplify, we revised the IRS' chart to only include the 15 reason codes which apply to IRAs.

Guide to Distribution Codes

Distribution Codes	Explanations	*Used with code ...(if applicable)
1—Early distribution, no known exception.	Use Code 1 only if the employee/taxpayer has **not** reached age 59½, and if none of the exceptions under distribution Codes 2, 3, or 4 apply when the distribution is made. Use Code 1 even if the distribution is made for medical, first-time homebuyer, or qualified higher education expenses, under section 72(t).	8, D, L, or P
2—Early distribution, exception applies.	Use Code 2 only if the distribution is: • A Roth IRA conversion (an IRA converted to a Roth IRA) or a reconversion if the participant is under age 59½, • An early distribution made from a qualified retirement plan or IRA because of an IRS levy under section 6331, • A section 457(b) plan distribution and not subject to the additional 10% tax. But see ***Section 457(b) plan distributions*** on page R-8 for these distributions that may be subject to the 10% additional tax, and • A distribution from a qualified retirement plan after separation from service where the taxpayer has reached age 55.	8, D, or P
3—Disability.	For these purposes, see section 72(m)(7).	None
4—Death.	Use Code 4 regardless of the age of the employee/taxpayer to indicate payment to a decedent's beneficiary, including an estate or trust. Also use it for death benefit payments made by an employer but not made as part of a pension, profit-sharing, or retirement plan.	8, A, D, G, L, or P
5—Prohibited transaction.	Use Code 5 if there was an improper use of the account. Code 5 means the account is no longer an IRA.	None
7—Normal distribution.	Use Code 7: **(a)** for a normal distribution from a plan, including a traditional IRA, if the employee/taxpayer is at least age 59½, **(b)** for a Roth IRA conversion or reconversion if the participant is at least age 59½, and **(c)** to report a distribution from a life insurance, annuity, or endowment contract and for reporting income from a failed life insurance contract under sections 7702(g) and (h). See Rev. Rul. 91-17, 1991-1 C.B. 190. Use Code 7 with Code A, if applicable. Generally, use Code 7 if no other code applies. **Do not** use Code 7 for a Roth IRA distribution.	A
8—Excess contributions plus earnings/ excess deferrals (and/or earnings) taxable in 2004.	Use Code 8 for an IRA or Roth IRA distribution under section 408(d)(4), unless Code P applies. Also use this code for corrective distributions of excess deferrals, excess contributions, and excess aggregate contributions, unless Code D or P applies. See **Corrective distributions** on page R-3 and **IRA revocation** on page R-2 for more information.	1, 2, 4, or J
G—Direct rollover and rollover contribution.	Use Code G for a direct rollover from a qualified plan (including a governmental section 457(b) plan) or tax-sheltered annuity to an eligible retirement plan (another qualified plan, a tax-sheltered annuity, or an IRA). See **Direct Rollovers** on page R-2. Also use Code G for certain distributions from conduit IRAs to an employer plan and IRA rollover contributions to an accepting employer plan. See **Conduit IRAs** on page R-2.	4
J—Early distribution from a Roth IRA.	Use Code J for a distribution from a Roth IRA when Code Q or Code T does not apply.	8 or P
N—Recharacterized IRA contribution made for 2004.	Use Code N for a recharacterization of an IRA contribution made for 2004 and recharacterized in 2004 to another type of IRA by a trustee-to-trustee transfer or with the same trustee.	None
P—Excess contributions plus earnings/ excess deferrals taxable in 2003.	See the explanation for Code 8. The IRS suggests that anyone using Code P for the refund of an IRA contribution under section 408(d)(4), including excess Roth IRA contributions, advise payees, at the time the distribution is made, that the earnings are taxable in the year in which the contributions were made.	1, 2, 4, or J
Q—Qualified distribution from a Roth IRA.	Use Code Q for a distribution from a Roth IRA if **you know** that the participant meets the 5-year holding period and: • The participant has reached age 59 ½, or • The participant died, or • The participant is disabled. **Note:** *If any other code, such as 8 or P applies, use Code J.*	None
R—Recharacterized IRA contribution made for 2003.	Use Code R for a recharacterization of an IRA contribution made for 2003 and recharacterized in 2004 to another type of IRA by a trustee-to-trustee transfer or with the same trustee.	None
S—Early distribution from a SIMPLE IRA in the first 2 years, no known exception.	Use Code S only if the distribution is from a SIMPLE IRA in the first 2 years, the employee/taxpayer has not reached age 59 ½, and none of the exceptions under section 72(t) are known to apply when the distribution is made. The 2-year period begins on the day contributions are first deposited in the individual's SIMPLE IRA. Do not use Code S if Code 3 or 4 applies.	None
T—Roth IRA distribution, exception applies.	Use Code T for a distribution from a Roth IRA if you **do not know** if the 5-year holding period has been met but: • The participant has reached age 59 ½, or • The participant died, or • The participant is disabled. **Note:** *If any other code, such as 8 or P applies, use Code J.*	None

*See the **Caution** for box 7 instructions on page R-8.