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ALSO IN THIS ISSUE –

RMD Notice & Withholding Notice — Can They Be Sent Together?, *Page 3*

Furnishing Recipients With Statements Electronically, *Pages 4*

How Many 5498s Must an Institution Prepare for an Accountholder, *Page 4*

Procedures for an Inherited IRA, *Page 5*

The Special Contributions Credit, *Page 6*

Miscellaneous Consulting Questions, *Page 7*

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"The Pension Specialists"

Combined IRA Reporting Forms to be Furnished to IRA Accountholders and Inheriting Beneficiaries

January is getting closer. In January, an IRA custodian has three tasks to perform. You are required to furnish the RMD Notice, the December 31, 2004 fair market value (FMV) statement and the Form 1099-Rs. You must furnish all three to IRA accountholders, if applicable. You must furnish the FMV statement and the 1099-R forms to inheriting IRA beneficiaries, but you are not required to furnish an RMD notice. CWF suggests, however, that you do.

Do the IRS rules allow an IRA custodian to furnish a statement that has a section providing the required fair market value information and another section providing the RMD Notice information? The answer is "yes."

The IRS has extensive rules governing "Specifications for Substitute Forms 1096, 1098, 1099, 5498, W-2G and 1042-S." The IRS issued these rules when it issued Revenue Procedure 2004-58 as reprinted from IR Bulletin 2004-41, dated October 12, 2004.

A financial institution, including an IRA custodian, is not required to use the official IRS form to furnish statements to recipients. A financial institution may choose to furnish an acceptable substitute statement. To be acceptable, certain rules must be met. There are rules for Forms 1099-INT, 1099DIV, 1099-OID and 1099-PATR, and there are other rules for other forms such as the Form 1099-Q, Form 1099-R, Form 5498, Form 5498-ESA and Form 5498-SA. The rules for Form 1099-INT are much stricter than the rules for the IRA forms.

To be acceptable, a substitute form/recipient IRA statement/form must meet the following requirements. Be aware that the IRS has issued an official version of the Form 1099-R and Form 5498, but the IRS has not issued an official version of the FMV statement or the RMD Notice. The IRS has instructed, however, what needs to be set forth on the FMV statement and the RMD Notice.

The FMV statement to be furnished on or before January 31, 2005, must show the account balance as of December 31, 2004, and it must also contain the following legend:

Continued on page 2

IRS Issues 2005 COLAs

IRS Announces Cost-of-Living Adjustments for 2005
The IRS in News Release No. IR-2004-127 Released its 2005 Adjustments as Follows:

	2003	2004	2005
Taxable Wage Base — OASDA Only	$87,000	$87,900	$90,000
SEP and Qualified Plan			
Maximum Compensation Cap – 401(a)(17) & 404(e)	$200,000	$205,000	$210,000
Elective (Salary) Deferral Limit – 401(k) & SAR-SEP	$12,000	$13,000	$14,000
Elective Deferral Catch-up Limit	$2,000	$3,000	$4,000
SIMPLE Deferral Limit – 408(p)(2)(A)	$8,000	$9,000	$10,000
SIMPLE Catch-up Limit	$1,000	$1,500	$2,000
Highly-Compensated Employees (Compensation as Indexed)	$90,000	$90,000	$95,000
Defined Benefit Limit – Section 415(b)(1)(A)	$160,000	$165,000	$170,000
Defined Contribution Limit – Section 415(c)(1)(A)	$40,000	$41,000	$42,000
SEP Minimum Compensation Threshold – 408(k)(2)(c)	$450	$450	$450

Combined IRA Reporting, Continued from page 1

"This information is being furnished to the Internal Revenue Service" and it must indicate which information is being furnished to the IRS (i.e. the FMV amount).

Refer to the following article for a discussion of the information required to be set forth within the RMD Notice.

To be acceptable, an IRA substitute/form recipient statement must meet the following requirements:

1. The tax year, form number, and form name must be the same as the official form and must be displayed prominently together in one area on the statement. For example, they may be shown in the upper right part of the statement.

2. The filer's and the form recipient's identifying information required on the official IRS form must be included.

3. With respect to the 1099-R, 1099-SA, 5498, 5498-ESA and 5498-SA, the custodian is encouraged to furnish a telephone number. With respect to the Form 1099-Q, the custodian must include the direct access telephone number of an individual who can answer questions about the statement.

4. All applicable money amounts and information, including box number, required to be reported to the form recipient must be titled on the form recipient's statement in substantially the same manner as those on the official IRS form. The box caption "Federal income tax withheld" must be in bold face type on the form recipient's statement.

If federal income tax is shown on the Form 1099-R as withheld, then the IRA custodian must furnish the recipient with Copy B and Copy C. For convenience, the IRA custodian can elect to furnish both copies to all recipients of the Form 1099-R.

5. The IRA custodian must provide appropriate instructions to the form recipient similar to those on the official IRS form, to aid in the proper reporting on the form recipient's income tax return.

CWF's comment: A mistake many data processor's make is that they omit the instructions.

6. In order to handle the reporting of state income tax withholding and state payments, the IRA custodian may add additional boxes as appropriate.

7. Logos are permitted on the substitute IRA reporting forms.

8. The IRA substitute statements must contain the following legends, as applicable.

On Copy B of Form 5498 - "This information is being furnished to the Internal Revenue Service."

On the Fair Market Value Statement - "This information is being furnished to the Internal Revenue Service." Note this legend and an indication of what information is being furnished to the IRS is required only if the IRA custodian does not furnish a copy of the Form 5498 to those people who did not make any type of reportable contribution.

On Copy B of Form 5498-ESA - "The information in boxes 1 and 2 is being furnished to the Internal Revenue Service."

On Copy B of Form 5498-SA - "The information in boxes 1 through 6 is being furnished to the Internal Revenue Service."

On Copy B of Form 1099-R - "Report this income on your federal tax return. If this form shows federal income tax withheld in box 4, attach this copy to your return."

On Copy C of Form 1099-R - "This information is being furnished to the Internal Revenue Service."

On Copy B of Form 1099-SA - "This information is being furnished to the Internal Revenue Service."

On Copy B of Form 1099-Q - "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."

Rules for Composite IRA Statements

The IRS also has extensive rules governing composite substitute statements. This article covers the rules for IRA composite statements. It does NOT cover the rules for 1099-INT and other non-IRA forms.

In section 4.2.2, the IRS states that a composite form/recipient statement may be furnished by one filer when there is more than one type of payment during the calendar year to the same form recipient. The forms that can be combined are: certain Forms 1098, 1099, 5498 and W-2G. Note that the IRS uses the term payment, but we at CWF believe the IRS also means to include the 5498 forms which have nothing to do with payments.

The IRS indicates that a composite statement will be acceptable only if the following requirements are met:

1. All information pertaining to a particular type of payment must be located and blocked together on the form and separate from any information covering other types of payments (i.e forms) included on the form.

2. The composite form/recipient statement must prominently display the tax year, form number, and form name of the official IRS form together in one area at the beginning of each appropriate block of information.

3. A composite statement is an acceptable substitute only if the type of payment and the recipient's tax obligation with respect to the payment are as clear as if each required statement were furnished separately on an official form.

4. Any information required by the official IRS forms that would otherwise be repeated in each information block is required to be listed only once in the first information block on the composite form. For example, there is no requirement to report the name of the filer in each information block.

Combining Recipient IRA Forms With Other Forms or Reports

The statement mailing requirements which apply to the form 1099-INT and 1099-DIV do NOT apply to the IRA reporting

Continued on page 3

The Pension Digest

Combined IRA Reporting, Continued from page 2

forms. An IRA custodian may combine the composite substitute statements with other reports or financial or commercial notices, or expand them to include other information of interest to the recipient. This means you can furnish an IRA amendment, if appropriate, or you may furnish IRA marketing materials.

Number of Copies to Be Furnished to the Recipient

Only one copy of Forms 5498, 5498-SA, 5498-ESA, 1099-Q, 1099-SA is required to be furnished to the recipient. The IRA custodian, of course, keeps a copy for itself. It does not appear that there is a copy for any state, city or local tax department.

There needs to be three (3) copies of the Form 1099-R furnished to the recipient: Copy B, Copy C, and Copy 2—attach this copy with your state, city or local income tax return, when required.

Conclusion

An IRA custodian (or its data processor), in order to save the costs associated with the printing and mailing of multiple IRA reporting forms, may create a combined reporting form. This article has been written to remind you of these rules. Your institution must consider these rules as you plan how you will comply with the three statements (Form 1099-R, FMV statements and the RMD notice) you are required to furnish your IRA accountholders and inheriting IRA beneficiaries in January of 2005. The IRS, in general, can assess a $50 penalty for each and every noncomplying statement.

RMD Notice & Withholding Notice—Can They Be Sent Together?

As discussed below, there may be some instances where it would be permissible to send the RMD Notice and Withholding Notice together.

The RMD Notice

This notice is required to be furnished to the accountholder by January 31 of each year, informing the accountholder that they are required to take an RMD from their account for the year in question. This notice must be sent to accountholders who will turn age 70½ during the year and those already in distribution. At the present time, the IRS does not require that you send it to inheriting beneficiaries. We suggest that you do.

IRS Notice 2002-27 is the authority governing the RMD notice. The IRS authorizes two alternatives.

Alternative #1 — The RMD notice must meet these three requirements:

a. Inform the recipient of the dollar amount of their distribution.

b. State the date by which such distribution must be made.

c. Include a statement which informs the recipient that you (the IRA custodian) are reporting to the IRS that this individual is required to receive a required distribution for 2005.

Alternative #2 — The RMD notice must also meet three requirements.

a. Inform the accountholder that they are required to take a distribution for the calendar year and offer, upon their request, to calculate the amount of the RMD.

b. State the date by which such distribution must be made.

c. Include a statement which informs the recipient that you (the IRA custodian) are reporting to the IRS that this individual is required to receive a required distribution for 2005.

Note that (b) and (c) are the same under both alternatives. The difference in the two alternatives is that under #1, the IRA custodian calculates the amount of the RMD, and under #2, the IRA custodian simply notifies the accountholder that they are required to take an RMD and offers to calculate the amount upon the accountholder's request.

It is our experience that most financial institutions neglect to include requirement (c) on the RMD notice. To be in IRS compliance, you must include a statement that you will be reporting to the IRS that the accountholder is required to take a required distribution for 2005.

The IRS has stated that an IRA custodian may use both alternatives. As an example, an institution may use Alternative #1 for its accountholders who are already in distribution, and may use Alternative #2 for those accountholders for whom the current year is their first year for a required distribution. The IRA custodian may use their discretion and may use one or both methods to meet the notice requirement.

For your information, CWF has created seven versions of the RMD notice (Form #62), all of which are IRS compliant. These are available by contacting our sales department.

The Withholding Notice

The withholding rules state that if a distribution is periodic and is paid four or more times per year, only one withholding notice needs to be furnished during the year. However, if a periodic distribution is paid one to three times per year, or is non-periodic, the withholding notice must be furnished for each distribution, but no more than six months in advance and within a reasonable time period prior to the distribution to allow the accountholder to change their withholding, if desired. Therefore, because of the "no more than six months in advance" rule, it is not always possible to send the withholding notice with the January RMD notice, depending on how an accountholder's distributions are timed. To send the withholding notice in January to an accountholder who takes his/her distribution once per year any time after July 1, would be out of compliance.

CWF believes this rule is extremely burdensome to IRA custodians, who have many customers who may take an annual (considered periodic) distribution. We will be writing the IRS to ask if they would consider changing this rule so that the withholding notice could be sent with the RMD notice and

Continued on page 4

RMD Notice & Withholding Notice
Continued from page 3

January statement. In other words, we would ask that they abolish the "no more than six months in advance" rule, so that it would be permissible to send the withholding notice in January for anyone required to take a distribution in that year. We believe if it was brought to the IRS' attention, they would consider changing this rule.

You also want to be aware that in order to be in IRS compliance, the withholding notice must include a discussion of the withholding rules. You will want to use a form such as CWF Form #59-B or 59-C, which provides a discussion of the withholding rules on the reverse side.

Furnishing Recipients With Statements Electronically

The IRS has authorized an IRA custodian and other filers to furnish statements electronically rather than with paper forms.

The 2004 Instructions for Forms 1099, 1098, 5498 and W-2G summarize the rules as follows:

Electronic recipient statements. If you are required to furnish a written statement (Copy B or an acceptable substitute) to a recipient, then you may furnish the statement electronically instead of on paper. This includes furnishing the statement to recipients of Forms 1098, 1098-E, 1098-T, 1099-A, B, C, CAP, DIV, H, INT, G, LTC, MISC, OID, PATR, Q, R, S, SA, 5498, 5498-ESA, and 5498-SA. It also includes Form W-2G (except for horse and dog racing, jai alai, sweepstakes, wagering pools, and lotteries).

If you meet the requirements listed below, you are treated as furnishing the statement timely.

Consent. The recipient must consent in the affirmative and not have withdrawn the consent before the statement is furnished. The consent by the recipient must be made electronically in a way that shows that he or she can access the statement in the electronic format in which it will be furnished.

You must notify the recipient of any hardware or software changes prior to furnishing the statement. A new consent to receive the statement electronically is required after the new hardware or software is put into service.

Prior to furnishing the statements electronically, you must provide the recipient a statement with the following statements prominently displayed:

• If the recipient does not consent to receive the statement electronically, a paper copy will be provided.

• The scope and duration of the consent. For example, whether the consent applies to every year the statement is furnished, or only for the January 31 immediately following the date of the consent.

• How to obtain a paper copy after giving consent.

• How to withdraw the consent. The consent may be withdrawn at any time by furnishing the withdrawal in writing (electronically or on paper) to the person whose name appears on the statement. Confirmation of the withdrawal also will be in writing (electronically or on paper).

• Notice of termination. The notice must state under what conditions the statements will no longer be furnished to the recipient.

• Procedures to update the recipient's information.

• A description of the hardware and software required to access, print and retain a statement, and a date the statement will no longer be available on the web site.

Format, posting, and notification. Additionally, you must:

• Ensure the electronic format contains all the required information and complies with the applicable revenue procedure for substitute statements to recipients. See Pub. 1179.

• Post, on or before the January 31 due date, the applicable statement on a web site accessible to the recipient through October 15 of that year.

• Inform the recipient, electronically or by mail, of the posting and how to access and print the statement. For more information, see Regulations section 31.6051-1. For electronic furnishing of Forms 1098-E and 1098-T, see Regulations section 1.6050S-2. For electronic furnishing of Forms 1099-R, 1099-SA, 1099-Q, 5498, 5498-ESA, and 5498-SA, see Notice 2004-10, 2004-6 I.R.B. 433.

How Many 5498s Must an Institution Prepare for an Accountholder?

A bank converted to Jack Henry software for IRA administration sometime prior to the mandatory reporting date for 2003 Form 5498s. This bank had a customer who has seven separate IRA plan agreements. The bank called to ask if a 5498 needed to be prepared for each plan agreement. The bank stated that the Jack Henry software aggregated all the IRAs onto one 5498 for 2003 reporting. CWF responded that we believe a 5498 needed to prepared for each plan agreement. The specific instructions from the IRS for Forms 1099-R and 5498 follow. These instructions clearly state that for both reporting forms, a form must be prepared for each plan agreement.

Specific Instructions for Form 5498 (2004)

File Form 5498, IRA Contribution Information, with the IRS by May 31, 2005, for each person for whom in 2004 you maintained any Individual Retirement Arrangement (IRA), including a deemed IRA under section 408(q).

An IRA includes all investments under one IRA plan. It is not necessary to file a Form 5498 for each investment under one plan. For example, if a participant has three certificates of deposit (CDs) under one IRA plan, only one Form 5498 is

Continued on page 5

The Pension Digest

How Many 5498s Must an Institution Prepare?
Continued from page 4

required for all contributions and the fair market values (FMVs) of the CDs under the plan. ***However, if an individual has established more than one IRA plan with the same trustee, a separate Form 5498 must be filed for each plan"*** (emphasis added).

Specific Instructions for Form 1099-R (2004)

An IRA includes all investments under one IRA plan or account. File only one Form 1099-R for distributions from all investments under one plan that are paid in 1 year to one recipient, unless you must enter different codes in box 7. You do not have to file a separate Form 1099-R for each distribution under the plan.

If there are multiple investments under one plan agreement, the instructions are clear that only one form would need to be prepared.

Because in the situation above, the reporting was done incorrectly for 2003, technically it should be corrected. However, the bank may incur IRS penalties—the penalty for not preparing and submitting a form when it is required is $50 per form. CWF recommends asking for Jack Henry's position on this matter, as obviously, the fault lies in the way their software handles multiple IRA plan agreements. This bank will undoubtedly want to make sure they have corrected the problem prior to the 2004 reporting.

CWF believes the "per plan" reporting rule is an important rule. An IRA is a separate tax entity, and, as long as it meets the rules, it receives preferential tax treatment. IRAs can be invested in many things, such as loans, real estate, etc., besides the normal mutual fund and bank investments. Such variety of investments can, at times, lead to a prohibited transaction (PT), if the accountholder is not extremely careful. The penalty for a PT is that the entire account is deemed distributed to the accountholder in the year the PT occurred. This is a very harsh tax consequence. Therefore, with each plan agreement being a separate tax entity, should a PT occur, only the IRA from which the funds were taken would be penalized (deemed distributed).

Obviously, a Roth IRA and traditional IRA have separate plan agreements, and therefore cannot be combined onto one 5498. As stated earlier, your institution will want to be certain your software provider is preparing all governmental reporting correctly.

Procedures for an Inherited IRA

Set forth below is CWF's response to a bank which had an inherited IRA question. The situation was follows. The original IRA accountholder was David Walker. He died in 2003. He died after his required beginning date. An inherited IRA was established for his wife, Mary Walker. It was titled, "Mary Walker as beneficiary of David Walker's IRA." Mary designated her niece (Debra Colson) to be her beneficiary. Mary's date of birth was 5/4/1928. Mary died on 11/11/04. The RMD distribution for 2004 had not been distributed to her.

Discussion of the Procedures With Respect to Establishing an Inherited IRA for Debra Colson

You will want to establish an inherited IRA for Debra Colson. I believe you should title the account, "Debra Colson as beneficiary of David Walker's IRA." The IRS has not given definitive guidance on how to title the account after the first inheriting beneficiary dies. From a tax logic standpoint I believe it makes more sense to reference the original IRA accountholder and not the first inheriting IRA beneficiary. I also don't believe it should be necessary to reference Mary. That is, I don't think you need to title the account, "Debra Colson as beneficiary of Mary Walker as beneficiary of David Walker's IRA."

Most IRA custodians will create the inherited IRA for Debra by transferring the funds from Mary's inherited IRA to Debra's inherited IRA. This transfer is not required to be reported and is not reported to the IRS. As a customer service, you may show the transfer out of Mary's inherited IRA on Mary's January FMV statement and the transfer in on Debra's January FMV IRA statement. Showing the transfers is permissive, it is not required. Many people believe the IRS must want to be told about the movement of funds from the first inherited IRA to the second inherited IRA, but the IRS does not.

The 2004 RMD amount as calculated for Mary must be paid to Debra Colson by December 31, 2004. The 2004 RMD amount cannot be paid to Mary, since she has died. Debra will pay the income tax, not Mary or Mary's estate. The person who "receives" the payment is the person who owes/pays the income tax.

I presume you sent Mary an RMD notice in January of 2004, setting forth the 2004 RMD amount. This is the amount which now needs to be paid to Debra. You would have calculated this amount by using the 12/31/03 account balance and dividing this balance by 12.7. The 12.7 comes from the single life table, as Mary was age 76 in 2004.

Debra Colson would have the right to take any amount larger than the 2004 RMD amount, including a lump-sum distribution. Again, Debra will pay income tax with respect to whatever amount she is paid during a given year.

Debra Colson should now designate her own beneficiary(ies).

Continued on page 6

Procedures for an Inherited IRA, Continued from page 5

Debra Colson will be required to take a required distribution for 2005. This is Situation #4 as discussed on page 12-36 of CWF's IRA Procedures Manual.

The formula to be used for 2005–2016 is: preceding December 31 balance (e.g. 12/31/04 for 2005) divided by the life-expectancy factor. There is an initial life-expectancy factor of 12.7 determined for the year Mary died (2004) and then this number is reduced by one for each subsequent year.

2004	12.7	(the initial year)
2005	11.7	(12.7-1)
2006	10.7	(12.7-2)
2007	9.7	etc.
2008	8.7	
2009	7.7	
2010	6.7	
2011	5.7	
2012	4.7	
2013	3.7	
2014	2.7	
2015	1.7	
2016	All out	

If Debra Colson would die before the account is closed, the formula as discussed above continues to apply to her beneficiary(ies). The beneficiary(ies), of course, could also take more than the required minimum amount.

You will need to prepare a January FMV statement and/or final 2004 Form 5498 for Mary; the account should be titled, "Mary Walker as beneficiary of David Walker's IRA."

You will need to prepare a January FMV statement and/or 2004 Form 5498 for Debra; the account should be titled, "Debra Colson as beneficiary of David Walker's IRA."

I would suggest that Debra complete CWF's 40-TI form. This form allows her to designate her own beneficiaries. You should also put a copy of David Walker's last IRA plan agreement along with a copy of Mary's designation of Debra as her beneficiary in Debra's file.

Debra will also want to complete CWF's Form 204 to instruct whether she wishes to be paid just the RMD amount or an amount greater than the RMD amount.

Much of what I have said in this letter is covered in Chapter 12 of our IRA Procedures Manual. You really should obtain this manual. You, as some others, may not have obtained the IRA Procedures Manual because you like the "seminar" manuals. The seminar manuals are not meant to be as comprehensive as the IRA Procedures Manual is.

The Special Contributions Credit

Many taxpayers, tax advisors and bankers are not as familiar with the contributions credit as they should be. A tax credit is extremely valuable. In order to be eligible to claim this tax credit, a person must have made a contribution to a traditional IRA, Roth IRA or 401(k) plan and must meet certain income guidelines.

Some individuals should realize the tax credit is sufficiently valuable that they should obtain a loan if they do not have the funds to make the contribution. The tax credit is that valuable.

This credit is designed for individuals with low and moderate incomes. More people than do should take advantage of this tax-planning opportunity. Contrary to what many people believe, all of the good tax planning tools do NOT belong to the wealthy. This tool belongs to those with low or moderate incomes.

Set forth is Tax Tip 2004-50 on the Retirement Savings Credit.

Retirement Savings Contribution Credit

Tax Tip 2004-50, March 12, 2004

This tax credit, which will be available only through 2006, could help you offset the cost of the first $2,000 contributed to IRAs, 401(k)s and certain other retirement plans.

The Retirement Savings Contributions Credit applies to individuals with incomes up to $25,000 ($37,500 for a head of household) and married couples with incomes up to $50,000.You must also be at least age 18, not a full-time student, and not claimed as a dependent on another person's return.

The credit is a percentage of the qualifying contribution amount, with the highest rate for taxpayers with the least income, as shown below:

Credit Rate	Income for Married, Joint	Income for Head of Household	Income for Others
50%	up to $30,000	Up to $22,500	Up to $15,000
20%	$30,001–32,500	$22,501–24,375	$15,001–16,250
10%	$32,501–50,000	$24,376–37,500	$16,251–25,000

When figuring this credit, you must subtract the amount of distributions you have received from your retirement plans from the contributions you have made. This rule applies for distributions starting two years before the year the credit is claimed and ending with the filing deadline for that tax return.

Form 8880, Credit for Qualified Retirement Savings Contributions, is used to figure the amount of the credit, which is then reported on line 48 of Form 1040 or line 32 of Form 1040A. You cannot use Form 1040EZ to claim this credit.

Using Form 8880 for your 2003 tax return, you would first subtract distributions received from January 1, 2001, through April 15, 2004, from your total 2003 retirement contributions. Then you would multiply (but not more than $2,000) by the credit rate that applies to your filing status and income level. The maximum credit amount allowed for 2003 is $1,000, or up to $2,000 if married filing jointly and each spouse made contributions.

The subtraction rule does not apply to distributions which are rolled over into another plan or to withdrawals of excess contributions.

The Retirement Savings Contributions Credit is in addition to whatever other tax benefits may result from the retirement contributions. For

Continued on page 7

The Pension Digest

example, most workers at these income levels may deduct all or part of their contributions to a traditional IRA. Contributions to a 401(k) plan are not subject to income tax until withdrawn from the plan.

For more information, review IRS Publication 590, Individual Retirement Arrangements (IRAs). The publication and forms can be downloaded from http://www.irs.gov or ordered by calling toll free-1-800-TAX-FORM (1-800-829-3676).

Miscellaneous Consulting Questions

Q1. How are the RMD life-expectancy factors determined for the following situation? The IRA owner dies in 2004 when she is age 64. Her beneficiary is her son who attains age 40 in 2004, and 41 in 2005. Do you use the factor for age 40 and then reduce that factor by one for each subsequent year, or do you use the factor for age 41 and then reduce it by one for each subsequent year?

A1. You use age 41 and reduce it by one for each subsequent year.

The accountholder died in 2004, before his or her required beginning date, and the beneficiary is a son. CWF has prepared a summary showing six situations. This would be Situation #3 of such list.

Under the life-distribution rule, the first year for which the son is required to take a distribution is the year after the year of the accountholder's death. This is 2005.

The account balance to be used in the RMD formula for 2005 is the 12/31/04 balance.

The factor to be used for the 2005 calculation is based on the age of the son in 2005. Since he will be 41, the factor will be 42.7 for 2005. For 2006 and subsequent years the factor is determined by subtracting 1.0 from the 42.7 for each year elapsed since 2005.

Q2. How are the RMD life-expectancy factors determined for the following situation? The IRA owner dies in 2004 when she is age 74. Her beneficiary is her estate. Do you use age 74 and then reduce that factor by one for each subsequent year, or do you use age 75 and then reduce that factor by one for each subsequent year?

A2. You use age 74 to determine the initial factor and then you reduce it by one for each subsequent year.

The accountholder died in 2004, after her required beginning date, and the beneficiary is her estate. CWF has prepared a summary showing six situations. This would be Situation #6 of such list.

Before discussing this situation, I wish to state the general rule that the RMD calculation/determination for a given year does not change, even when the accountholder dies. To the extent the RMD had not been paid to the accountholder, it will need to be paid proportionately to the beneficiary(ies). There is one major exception to the general rule. If the accountholder dies before attaining his or her required beginning date (e.g. during the 70$^1/_2$ year), then the RMD as calculated for such first year is no longer required to be distributed.

The accountholder died in 2004 after his or her required beginning date and the beneficiary was the estate.

The five-year rules does not apply since this is an "on or after" situation. The general rule is that the RMD schedule applying to the accountholder continues to apply after his or her death. For simplicity reasons, the new RMD rules change this to be based on the life of the beneficiary rather than the joint life-expectancy of the accountholder and the beneficiary. In this situation where the estate is the beneficiary the IRS created a special rule – use the life-expectancy of the accountholder in the year of death to determine the initial factor and subtract one for each subsequent year.

Q3. What are the elective deferral limits for 2004 and 2005 and how do these limits apply when a person is covered under more than one elective deferral plan (401(k), 403(b), 457, 408(p))?

A3. The elective deferral limits are as follows:

	Elective Deferral	Catch-Up*	Total
2004	$13,000	$3,000	$16,000
2005	$14,000	$4,000	$18,000

Individuals age 50 or older are eligible to make catch-up contributions.

Most pension plan limits apply to employers and not to employees. For example, the law states that the most an employer may contribute to a profit sharing plan or SEP plan on behalf of an employee is the lesser of $41,000 or 25% or his compensation. If a person is lucky enough to work for two "unrelated" employers, then the person may receive two contributions of $41,000 assuming the person's income is sufficiently high.

The elective deferral limits, however, apply on a per employee basis.

An individual who is at least age 50 on or before December 31 of a year is entitled to make a catch-up contribution subject to the $3,000 or $4,000 limit, applicable.

For 2004 a person under age 50 is not entitled to make elective deferrals exceeding $13,000 regardless of the fact that she participates in a 401(k) plan sponsored by one employer and a 403(b) plan sponsored by a second employer. Thus, if she defers $10,000 under the 401(k) plan and $5,000 under the 403(b) plan she will have adverse tax consequences for doing so. Her taxable income will increase by $2,000, since she is only permitted to defer $13,000. She is responsible to inform one of the employers of her error. That employer will need to revise her Form W-2 to show the lesser elective deferral amount.

Another example for 2004 would be as follows. An individual, age 45, participates in a 401(k) plan and defers

Continued on page 8

Miscellaneous Consulting Questions, Continued from page 7

$10,000. She also is self-employed and elects to defer $8,000 under a SIMPLE-IRA plan. She is unaware of the rule that requires her to aggregate all of her elective deferrals regardless of who the employer is. Her taxable income will increase by $5,000, since she is only permitted to defer $13,000 for 2004.

Q4. A two-person partnership has $28,000 of gross revenues, expenses of $10,000 and a net profit of $18,000. Each partner is allocated $9,000 of the net earnings. How much may be contributed to a SIMPLE-IRA plan?

A4. The general rule is that a self-employed person may not make a pension contribution for himself larger than his net earnings for the year. In similar fashion, the general rule is that a person may not defer more than his or her compensation. Compensation for a self-employed person is not one's net earnings from the business. Rather, it is the net earnings as reduced by 1/2 of his or her self-employment tax.

Consequently, if a person has net earnings of $9,000, then this $9,000 will need to be reduced by 1/2 of the applicable self-employment tax. It is this lesser amount which will be the maximum contribution amount (elective deferral plus the matching contribution amount).

Q5-A. A person has an HSA. He uses his HSA debit card and withdraws $100, but only $60 of it is used to pay qualified medical expenses. He uses the other $40 for nonmedical reasons. What will be the tax consequences of his not using the withdrawn funds exclusively to pay qualified medical expenses. Does he have to pay income tax on the $100 or the $40?

A5-A. In order to receive tax-free income treatment, the rule is clear that a distribution must be used exclusively to pay for qualified medical expenses. Thus, withdrawing $100 and using $60 to pay qualified medical expenses and $40 for non-qualified medical expenses, could lead to the result that the entire $100 would be taxable. However, in Q/A-25 of Notice 2004-2, the IRS adopted a more reasonable rule: "any amount of a distribution not used exclusively to pay for qualified medical expenses is includable in the gross income of the account owner and subject to the 10% additional tax, if applicable." Thus, only the $40 would be includable in income, and not the entire $100.

Q5-B. In Notice 2004-2, Q/A the IRS defined a qualified medical expense as one which occurs after the HSA has been established. In Notice 2004-25 the IRS created a transitional rule which allowed an HSA owner to exclude from income an HSA distribution used to pay a medical expense incurred in 2004 even though the HSA was not set up prior to the incurrence of the medical expense, as long as the HSA was set up by April 15, 2005. Does this transitional rule apply for 2005 purposes?

A5-B. It does not. If the medical expense is incurred in 2005, it will qualify as a qualified medical expense and be excludable from income only if the HSA has been established prior to the incurrence of the medical expense. The special extension until April 15, 2005, applies for 2004 tax purposes, but not for 2005 tax purposes.

The special rule apparently applies only for tax year 2004 purposes. There is a special rule for 2004 with respect to whether the HSA must be established before the medical expense has been incurred in order to receive tax-free income treatment. For the 2004 calendar year, it will be permissible for an eligible individual to establish an HSA on or before April 15, 2005, and to have the HSA pay, or reimburse on a tax-free basis, a qualified medical expense incurred on or after the later of January 1, 2004, or the first day the person was covered under a high-deductible health plan.

There is no special rule for calendar year 2005. The standard rule will apply—to be qualified, the medical expense must be incurred only after the HSA has been established. Thus, a person who incurs a medical expense of $800 on January 25, 2005, who establishes the HSA on February 15, 2005 for 2004 purposes by contributing $2,000, and who then withdraws $800 to reimburse herself, will not receive tax free treatment with respect to that $800 expense.

Q6. Must an IRA projection schedule take into account annual maintenance fees, transfer fees, and redemption fees?

A6. Until the IRS provides additional guidance, CWF believes all fees must be reflected in the projection schedules. The projection amounts must be determined using an earnings rate no greater than, and terms no different from, those currently in effect, assuming that there will be level annual contributions in the amount of $1,000 made on the first day of each year, and assuming the accountholder were to withdraw in a single sum the entire amount at the end of the first five years, at the end of the years in which he or she attains the ages of 60, 65, and 70, and at the end of any other year during which the increase of the amount available is less than the increase of the amount available during any preceding year for any reason other than decrease or cessations of contributions.

Although not stated expressly, in prior writings the IRS has made clear that the phrase, "terms no different from those currently in effect" does encompass all fees or charges to be charged by the custodian. Such fees, of course would lower the amount available to an accountholder.