THE Pension Digest

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Published Since 1984

ALSO IN THIS ISSUE –

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

Payroll-Deduction IRA Programs

Payroll-Deduction IRA Programs have lost favor with businesses and with IRA Custodians. The concept of these programs is so simple—an employer decides to help its employees save for their retirement by forwarding funds withdrawn from an employee's paycheck to an IRA custodian. Although one normally thinks of a payroll-deduction program as dealing with traditional IRAs, there is no reason there are not payroll-deduction programs for Roth IRAs. Note that the word "program" is used and not the word "plan." There is generally no plan document for an IRA payroll-deduction program. The employer must be willing to transmit the IRA funds to the IRA custodian as selected by each employee. In general, a business should be willing to offer this special service to all employees.

What is needed to have a payroll-deduction IRA program?

An employee needs to have established a traditional IRA and/or Roth IRA with an IRA custodian. The employee then needs to authorize the employer to deduct the IRA contribution amount from his paycheck.

The employer then must be willing to transmit the employee's authorized deduction contribution amount to the IRA custodian on a timely basis.

What contribution limits apply to payroll-deduction programs?

The standard IRA contribution limits apply, because it is the employee who is actually making the contribution for himself.

What administrative costs are associated with a payroll deduction program?

There will be costs associated with handling each employee's request, however, this cost should be nominal. An employer does not having any type of governmental reporting to submit under a payroll-deduction IRA pro-

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Keogh Close-Out in 2004 — Don't Forget the 2004 Form 5500-EZ

Many banks no longer service Keogh plans. Many of you who still have Keogh plans have had customers close out their Keoghs in 2004. Your Keogh participants have either taken total distributions or rolled their Keogh funds over to an IRA. In general, a Keogh plan is a retirement plan established by a self-employed person. Today, the plans are known as profit sharing plans, money purchase plans and one-person 401(k) plans. The 2001 EGTRRA law changes were so favorable that more small businesses (including one-person farmers and ranchers) will want a Keogh plan.

The purpose of this article, however, is not to discuss these favorable tax law changes. Rather, the purpose of this article is to remind you (<u>so you can remind your customers and their accountants</u>) that there must be a FINAL filing of Form 5500-EZ for the year during which the Keogh is closed out. A close-out occurs when all of the Keogh funds have either been distributed to the Keogh participant, paid out to the participant's spouse (or rolled over) or paid out to a nonspouse beneficiary. The general rule is that a Form 5500-EZ only need to be filed if the plan had a fair market value of more than $100,000. The $100,000 rule is overridden by the rule that says the Form 5500-EZ must be filed for the year all funds in the plan are distributed.

Also remember that a nonspouse beneficiary of a Keogh plan can NEVER roll over a distribution from the Keogh plan (or a corporate plan, for that matter) into an IRA. The Congress has considered law changes to allow such rollovers, but the current law does not authorize any such rollover.

Payroll-Deduction IRA Programs, Continued from page 1

gram. The employer prepares an employee's Form W-2 in the usual manner regardless of whether or not an IRA program is in place. It is left up to the employee to properly reflect the tax effect of this traditional IRA contribution and/or Roth IRA contribution on his tax return. Since the employer has not made a contribution, it is generally not entitled to a deduction. However, any additional payroll costs the employer must pay to establish and operate the payroll program will be able to be claimed as a reasonable business deduction.

How does a payroll-deduction IRA work?

Susannah, age 25, works for Elite Tax Preparation Company which has offered its employees the opportunity to have deductions taken from their salaries to contribute to IRAs that the employees have set up for themselves. The employer makes the contributions by using electronic deposits. Susannah signs up for the program and has $125 per paycheck deposited into her Roth IRA. There are 24 payrolls per year. Her contributions total $3,000.

How does an employer end a payroll-deduction program?

It simply makes the decision to end the program. The employer will need to notify the employees of its discontinuance of the payroll deductions. If the employer uses a payroll service to assist with its payroll work, then the employer will want to notify this service provider also.

Is a payroll-deduction IRA program different from an Employer-Sponsored IRA plan?

Yes. The employer makes contributions with its funds under an employer-sponsored IRA plan, whereas the employer only transmits the employee's own funds under a payroll-deduction IRA program.

Summary.

You may wish to check with your business customers to see if they would want any assistance with operating a payroll-deduction IRA program. Although your best bet may be to offer assistance to employers without a 401(k) plan, there is nothing preventing a business with a 401(k) plan from also offering the payroll-deduction IRA program. Again, more people should be contributing to both 401(k) plans and making Roth IRA contributions. People should be making both types of contributions and not just the 401(k) contribution. A payroll-deduction IRA program should be a relatively simple way to increase the amount of contributions to Roth IRAs and traditional IRAs.

There are both traditional IRA payroll-deduction programs and also Roth IRA payroll-deduction programs.

In fact, one would expect there might be more employee interest in a Roth IRA payroll-deduction program, because an employee's participation in a 401(k) plan does not make one ineligible for a Roth IRA contribution.

Hardship Distributions from a 401(k) Plan Versus an IRA

Many 401(k) plans provide for a hardship distribution. In order to prevent misuse of 401(k) plans, the law requires that before a distribution from a 401(k) plan may occur, a triggering event must occur. In general, a triggering event which would allow a distribution would be: (1) separation or severance from service, (2) attaining age 59½, and (3) the occurrence of a hardship. The IRS has defined the conditions which must be met in order to take a hardship distribution. Set forth below are typical provisions included in a 401(k) plan with respect to hardship distributions:

1. Distributions of elective deferrals (and earnings thereon accrued as of December 31, 1988*) may be made to a participant in the event of hardship. For the purposes of this section, hardship is defined as an immediate and heavy financial need of the employee where such employee lacks other available resources. Hardship distributions are subject to the spousal consent requirements contained in sections 401(a)(11) and 417 of the Code, if applicable.

***CWF Note:** Earnings accrued **after** December 31, 1988 **are not** allowed to be distributed in a hardship situation.

2. The following are the only financial needs considered immediate and heavy; deductible medical expenses (within the meaning of section 213(d) of the Code) of the employee, the employee's spouse, children, or dependents; the purchase (excluding mortgage payments) of a principal residence for the employee; payment of tuition for the next quarter or semester of post-secondary education for the employee, the employee's spouse, children or dependents; or the need to prevent the eviction of the employee from, or a foreclosure on the mortgage of, the employee's principal residence.

3. A distribution will be considered as necessary to satisfy an immediate and heavy financial need of the employee only if:

- The employee has obtained all distributions, other than hardship distributions, and all nontaxable loans under all plans maintained by the employer;
- All plans maintained by the employer provide that the employee's elective deferrals (and employee contributions) will be suspended for twelve months after the receipt of the hardship distribution;
- The distribution is not in excess of the amount of an immediate and heavy financial need; and
- All plans maintained by the employer provide that the employee may not make elective deferrals for the employee's taxable year immediately following the taxable year of the hardship distribution in excess of the applicable limit under section 402(g) of the Code for such taxable year less

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Hardship Distributions,
Continued from page 2

the amount of such employee's elective deferrals for the taxable year of the hardship distribution.

The occurrence of a hardship makes it possible for the 401(k) participant to be able to take a distribution from the plan. The participant will owe income tax on the distribution and will also normally owe the 10% additional tax, if they have not yet attained the age of $59\frac{1}{2}$.

Distributions are permissible from most IRAs for any reason. There is no need to have a hardship in order to take a distribution, because an IRA accountholder is generally free to take a distribution whenever they want, as long as they are willing to pay the applicable taxes. However, the law does stipulate that, in some situations, the accountholder will not owe the 10% additional tax, even though he or she is younger than age $59\frac{1}{2}$. See pages 47-48 from the 2004 IRS Publication 590 describing when the 10% additional tax is not owed. Some of these reasons are the same as those which will qualify a person for a hardship distribution from a 401(k) plan.

One of the exceptions to the 10% additional tax is the use of IRA funds to pay certain medical expenses. Even if an accountholder is under age $59\frac{1}{2}$, he/she does not have to pay the 10% additional tax on distributions that are not more than:

- The amount paid for unreimbursed medical expenses during the year of the distribution, minus
- 7.5% of the accountholder's adjusted gross income (defined later) for the year of the distribution.

An accountholder can only take into account unreimbursed medical expenses that he/she would be able to include in figuring a deduction for medical expenses on Schedule A, Form 1040. An individual does not have to itemize deductions to take advantage of this exception to the 10% additional tax.

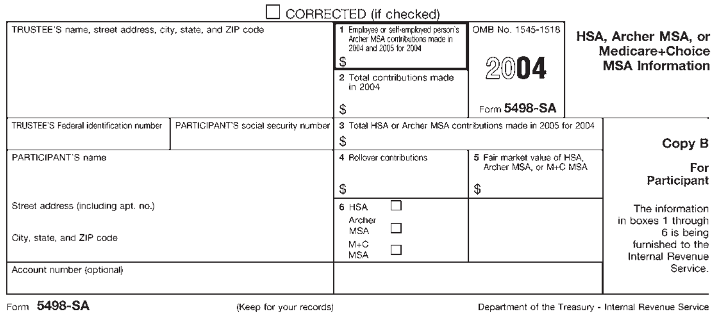
Adjusted gross income. This is the amount on Form 1040, line 37, or Form 1040A, line 22.

Whose medical expenses can be included on Schedule A? An individual may include medical bills paid for:

- Himself/herself and his/her spouse.
- All dependents eligible to be claimed on the individual's tax return
- A child not claimed as a dependent because of the rules explained in Publication 501 for children of divorced or separated parents.
- Any person the accountholder could have claimed as a dependent if that person had not received $3,050 (as indexed) or more of gross income or had not filed a joint return.

Example: An individual provided more than 1/2 of his mother's support, but may not claim her as a dependent because she received wages in excess of the amount which would have allowed the accountholder to claim her as his dependent. The accountholder may include on line 1 any medical expenses paid in 2004 for his mother.

Completing the 2004 Form 5498-SA


CORRECTED (if checked)
TRUSTEE'S name, street address, city, state, and ZIP code
1 Employee or self-employed person's Archer MSA contributions made in 2004 and 2005 for 2004 $
2 Total contributions made in 2004 $
OMB No. 1545-1518
2004
Form 5498-SA
HSA, Archer MSA, or Medicare+Choice MSA Information
TRUSTEE'S Federal identification number
PARTICIPANT'S social security number
3 Total HSA or Archer MSA contributions made in 2005 for 2004 $
PARTICIPANT'S name
4 Rollover contributions $
5 Fair market value of HSA, Archer MSA, or M+C MSA $
Street address (including apt. no.)
City, state, and ZIP code
6 HSA ☐ Archer MSA ☐ M+C MSA ☐
Account number (optional)
Copy B
For Participant
The information in boxes 1 through 6 is being furnished to the Internal Revenue Service.
Form 5498-SA (Keep for your records) Department of the Treasury - Internal Revenue Service

As with the 2004 Form 1099-SA, completing the Form 5498-SA is, for the most part, self evident. This form is used either to report contribution activity to an HSA or to one of the two types of MSAs. This article discusses completing the form for HSA contributions. It does not discuss completing the form for MSA purposes.

Set forth below are the IRS instructions as modified by CWF.

1. Statements to participants. If you are required to file Form 5498-SA, you must provide a statement to the participant (generally Copy B) by May 31, 2005. You may, but you are not required to, provide participants with a statement of the December 31, 2004, fair market value.

2. Box 1 will not need to be completed for an HSA, since it applies only to MSA contributions.

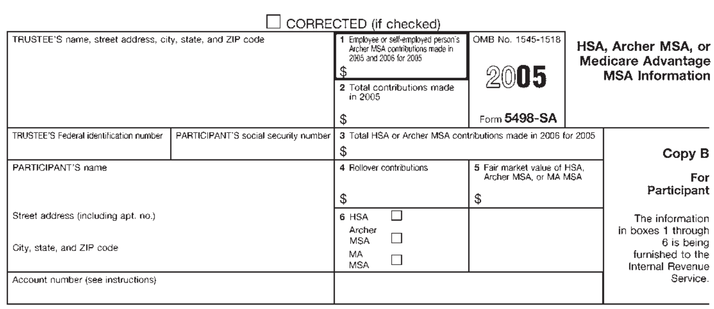
3. Box 2 is to be completed with the total of HSA contributions made in 2004.

4. Box 3 is to be completed with the total of HSA contributions made in 2005 for 2004.

5. Box 4 is to be completed with the total of rollover contributions as originating from an Archer MSA, or an HSA, to an HSA, as received by the HSA custodian during 2004.

6. Box 5 is to be completed with the fair market value of the HSA on December 31, 2004.

7. Box 6 — simply check the "HSA" box.


CORRECTED (if checked)
TRUSTEE'S name, street address, city, state, and ZIP code
1 Employee or self-employed person's Archer MSA contributions made in 2005 and 2006 for 2005 $
2 Total contributions made in 2005 $
OMB No. 1545-1518
2005
Form 5498-SA
HSA, Archer MSA, or Medicare Advantage MSA Information
TRUSTEE'S Federal identification number
PARTICIPANT'S social security number
3 Total HSA or Archer MSA contributions made in 2006 for 2005 $
PARTICIPANT'S name
4 Rollover contributions $
5 Fair market value of HSA, Archer MSA, or MA MSA $
Street address (including apt. no.)
City, state, and ZIP code
6 HSA ☐ Archer MSA ☐ MA MSA ☐
Account number (see instructions)
Copy B
For Participant
The information in boxes 1 through 6 is being furnished to the Internal Revenue Service.
Form 5498-SA (keep for your records) Department of the Treasury - Internal Revenue Service

As with the 2005 Form 1099-SA, the 2005 Form 5498-SA has the special instruction on the account number box in the lower left-hand corner.

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Completing the 2004 Form 5498-SA, Continued from page 3

The instructions state: The account number is required if you have multiple accounts for a recipient for whom you are filing more than one Form 5498-SA. Additionally, the IRS encourages you to designate an account number for all Forms 5498-SA that you file.

Completing the 2004 Form 1099-SA

☐ CORRECTED (if checked)

TRUSTEE'S/PAYER'S name, street address, city, state, and ZIP code			OMB No. 1545-1517 2004 Form 1099-SA	Distributions From an HSA, Archer MSA, or Medicare+Choice MSA
PAYER'S Federal identification number	RECIPIENT'S identification number	1 Gross distribution $	2 Earnings on excess contributions $	Copy B For Recipient
RECIPIENT'S name		3 Distribution code	4 FMV on date of death $	This information is being furnished to the Internal Revenue Service.
Street address (including apt. no.) City, state, and ZIP code		5 HSA ☐ Archer MSA ☐ M+C MSA ☐		
Account number (optional)				

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

Completing the Form 1099-SA for distributions from an HSA should be self evident. The gross distribution amount is entered in box 1. If there has been an excess contribution which has been withdrawn, then enter the earnings in box 2. Enter the distribution code in box 3. If the HSA accountholder has died, then report the fair market value (FMV) on the date of death in box 4. Check the "HSA" box in box 5. The IRS needed to provide guidance once the accountholder died, and they have done so.

Set forth below are the instructions as modified by CWF.

1. Transfers of MSA funds into an HSA are not reported, and transfers of HSA funds into another HSA are not reported.
2. Each and every distribution from an HSA is to be reported. The HSA custodian has no duty to determine the taxable amount of a distribution. Such distribution may have been paid directly to the HSA accountholder or to a medical service provider on the accountholder's behalf.
3. Box 1. Gross distribution.

   Enter the total amount of the distribution. Include any earnings separately reported in box 2. The gross distribution amount must always be reported in box 1.
4. Box 2. Earnings on excess contributions.

   Most of the time, this box will be left blank. This box is to be completed only if the excess HSA contribution plus the related earnings were withdrawn by the due date of the accountholder's tax return. Enter the total earnings distributed along with the excess. The earnings are reported separately in box 2, and then also reported in the total distribution amount as reported in box 1. The distribution of earnings from non-excess contributions are reported in box 1 and are NOT to be reported in box 2.
5. Distribution in year of death.

   If you learn of the accountholder's death and make a final distribution to the beneficiary in the year of death, issue a final Form 1099-SA and enter in:
   - Box 1, the gross distribution;
   - Box 3, code 4; and
   - Box 4, the FMV of the account on the date of death

   If the beneficiary is the estate, enter the estate's name and taxpayer identification number (TIN) in place of the recipient's on the form.
6. Distribution after year of death.

   If you learn of the death of the accountholder and make a final distribution after the year of death, issue a final Form 1099-SA in the year you learned of the death of the accountholder. Enter in:
   - Box 1, the gross distribution
   - Box 3, one of the following codes

     1—if the beneficiary is the spouse

     2—if the beneficiary is the estate, or

     3—if the beneficiary is not the spouse or estate;
   - Box 4, the FMV of the account on the date of death
7. The IRS has defined 6 distribution codes for use in completing box 3. The HSA custodian is to enter the appropriate code from the IRS list.

   1— Distributions: Use this code for normal distributions to the accountholder and any direct payments to a medical service provider. Use this code if no other code applies.

   Note: "1" is used to report distributions to a surviving spouse if they occur after the year of death.

   2— Excess contributions: Use this code for distributions of excess HSA contributions.

   3— Disability: Use this code if you made distributions after the accountholder was disabled (see section 72(m)(7).

   4— Death distribution other than code 6: Use this code for payments to a decedent's estate in the year of death. Also use this code for payments to an estate after the year of death. Do not use with Code 6.

   The IRS does NOT expressly state to use "4" for distributions to a spouse if made in the same year the accountholder died. The IRS implies it, however. The IRS should furnish additional guidance.

   5— Prohibited Transaction: See sections 220(e)(2) and 223 (e)(2).

   6— Death distribution after year of death to a nonspouse beneficiary: Use this code for payments to a decedent's nonspouse beneficiary, other than an estate, after the year of death. Do not use with code 4.
8. Box 4. FMV on date of death.

   If the accountholder died, enter the FMV of the account on the date of death.
9. Box 5. Checkbox.

   Check the HSA box to indicate if this distribution was from an HSA.

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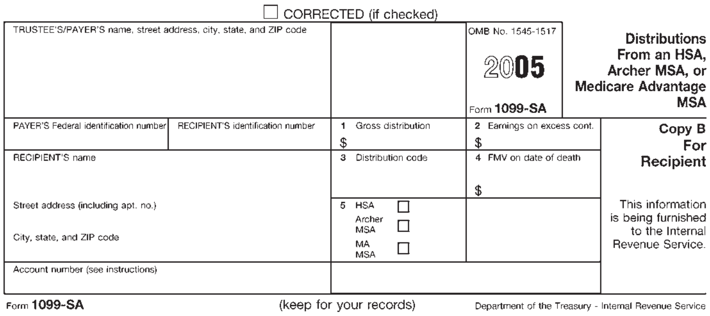
Completing the 2004 Form 1099-SA, Continued from page 4



CORRECTED (if checked)

TRUSTEE'S/PAYER'S name, street address, city, state, and ZIP code

OMB No. 1545-1517

2005

Form 1099-SA

Distributions From an HSA, Archer MSA, or Medicare Advantage MSA

PAYER'S Federal identification number	RECIPIENT'S identification number	1 Gross distribution $	2 Earnings on excess cont. $	Copy B For Recipient
RECIPIENT'S name		3 Distribution code	4 FMV on date of death $	
Street address (including apt. no.) City, state, and ZIP code		5 HSA ☐ Archer MSA ☐ MA MSA ☐		This information is being furnished to the Internal Revenue Service.
Account number (see instructions)				

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

The IRS has already issued the 2005 instructions for the 2005 Form 1099-SA. There are two basic changes from the 2004 instructions. The first change does not apply to HSAs.

1. The Working Families Tax Relief Act of 2004, Public Law 108-311, replaced “Medicare+Choice (M+C)” with “Medicare Advantage (MA) MSAs.”

2.There is a box for an “account number” in the lower left-hand corner.

The NEW instructions state: The account number is required if you have multiple accounts for a recipient for whom you are filing more than one Form 1099-SA. Additionally, the IRS encourages you to designate an account number for all forms 1099-SA that you file.

Comparison — HSAs and MSAs

1. Eligibility. Almost everyone could be eligible to establish an HSA. A person must simply accept being covered by a high-deductible health plan (HDHP). In contrast, only individuals related to certain small employers are eligible to establish an MSA.

HSAs. In order to open an HSA, an individual must meet the following four requirements: (1) be covered by an HDHP; (2) NOT be covered by a health plan which is not an HDHP; (3) NOT be able to be claimed as a dependent by another taxpayer; and (4) NOT be enrolled in Medicare.

MSAs. Two types of individuals are eligible to establish an MSA: (1) an employee of a small employer that maintains an individual or family high-deductible health plan covering that individual (the employee or spouse of the employee) and (2) a self-employed person (or the spouse of that person) maintaining a family or individual high-deductible health plan covering that individual (self-employed person or spouse). In general, an employer is a “small employer” for a calendar year if the employer employed an average of 50 or fewer employees during either one of the two preceding calendar years.

2. Minimum Deductible.

Coverage Type	HSA	MSA
Self-Only Coverage	$1,000	$1,700 (as indexed)
Family Coverage	$2,000	$3,350 (as indexed)

CWF Comment. The deductible requirement is much lower for the HSA versus the MSA. This will influence most people to go with the HSA.

3. Maximum Out-of-Pocket Limit.

Coverage Type	HSA	MSA
Self-Only Coverage	$5,000	$3,350 (as indexed)
Family Coverage	$10,000	$6,150 (as indexed)

CWF Comment. The out-of-pocket requirement is much lower for the MSA versus the HSA. This factor seems to favor the MSA, as individuals will prefer a lower out-of-pocket limit.

4. The Contribution/Deduction Limits. For the HSA, the contribution limit and the deduction limit are the same. This is not the case for the MSA, where the deduction limit is either 65% of the contribution amount (for self-only coverage) or 75% of the contribution amount for family coverage.

Self-only coverage. If the account beneficiary has single coverage, then the maximum ANNUAL HSA contribution is 100% of the lesser of the deductible (cannot be less than $1,000) or $2,600, whereas the MSA contribution is 65% of the annual deductible (must be within the range of $1,700 - $2,600). Note: A $2,600 contribution may be made to an HSA, whereas the MSA contribution is limited to $1,690 ($2,600 x 65%).

If the account owner has family coverage, then the maximum annual HSA contribution is 100% of the lesser of the

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Comparison—HSAs and MSAs, Continued from page 5

deductible (cannot be less than $2,000) or $5,150, whereas the MSA contribution is the 75% of the annual deductible which must be within the range of $3,350 - $5,150. Note: a $5,150 contribution may be made to an HSA, whereas, the MSA contribution is limited to $3,862 ($5,150 x 75%).

CWF Comment. Since the HSA rules permit a person to contribute 100% of his or her deductible, whereas the MSA limits the contribution to 65% or 75% of the deductible, the HSA clearly seems to be favored by the law.

5. Catch-up Contributions.

Coverage Type	HSA	MSA
Self-Only Coverage	Yes — $500 per person	No
Family Coverage	Yes — $500 per person	No

CWF Comment. In general, individuals between ages 55 and 64 are allowed to make a catch-up contribution to their HSA. This factor clearly favors the HSA over the MSA, since a person may not make a catch-up contribution to an MSA. The catch-up contributions increase over the next five years as follows:

Year	Amount of Catch-up Contribution
2004	$500
2005	$600
2006	$700
2007	$800
2008	$900
2009	$1,000

6. Additional Excise Tax.

HSA	MSA
10%	15%

CWF Comment. Since the excise tax is less (10% versus 15%) for a nonqualifying medical distribution from an HSA prior to age 65, this factor favors the HSA over the MSA.

7. Rollovers. A person may roll over a distribution from an MSA into another MSA or an HSA. However, a person may roll over a distribution from an HSA only into another HSA.

8. Transfers. A person may transfer a distribution from an MSA into another MSA, and a person may transfer a distribution from an HSA into another HSA. The IRS, at this time, has not said that it is possible to have a non-reportable transfer from an MSA to an HSA. Since the law does not authorize a rollover from an HSA to an MSA, the IRS will also not allow such a transfer.

Electronic and Magnetic Media Specifications for Filing Form 8851, *Summary of Archer MSAs*

Announcement 2004-83

The following are updates to Rev. Proc. 2001-31, electronic and magnetic specifications for filing Form 8831, Summary of Archer MSAs. The format for filing these forms remains the same; however, there are changes to the types of acceptable media and editorial changes.

1. The current reporting requirement is for Archer MSAs established from January 1, 2004, through June 30, 2004.

2. The Martinsburg Computing Center has been renamed Enterprise Computing Center—Martinsburg (ECC-MTB).

3. Call Site was renamed Information Reporting Program (IRP) Customer Service Section and can be reached at our toll-free number 866-455-7438.

4. ECC-MTB no longer accepts magnetic tapes, 8mm, 4mm or Quarter Inch Cartridges (QIC) for the filing of Forms 8851.

5. Electronic filing via the FIRE System is now an internet connection at *http://fire.irs.gov.* Filing procedures are essentially the same as the dial-up connection. Refer to Publication 3609, Rev. 10-2004 for detailed instructions.

Questions concerning the filing of Form 8851 can be directed to the IRP Customer Service Section toll-free at 866-455-7438.

Archer Medical Savings Accounts—Trustees' Reports on the Number of Archer MSAs Established Between January 1, 2004, and June 30, 2004

Announcement 2004-82

Purpose: The purpose of this announcement is to notify trustees and custodians that they must report to the Internal Revenue Service (IRS) the number of Archer MSAs established between January 1, 2004, and June 30, 2004. Trustees must report this information to the IRS on Form 8851, no later than January 3, 2005. Form 8851 is available at *www.irs.gov.*

Archer Medical Savings Accounts (Archer MSAs)

Archer MSAs are a pilot project authorized by section 220 of the Internal Revenue Code. The Working Families Tax Relief Act of 2004 § 322, amends sections 220(j)(4), (5) of the Code to require that trustees of Archer MSAs report the number of Archer MSAs established between January 1, 2004, and June 30, 2004. Trustees must report this information to the IRS

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Archer Medical Savings Accounts, Continued from page 6

by January 3, 2005. Trustees do not report Archer MSAs established in 2003. Archer MSAs will terminate if the number of individuals establishing Archer MSAs exceeds certain numerical limits. If these limitations are exceeded in 2004, 2004 will be a "cut-off year" after which, in general, no new Archer MSAs can be established. The IRS will publish, no later than February 1, 2005, the number of Archer MSAs established and whether 2004 is a cut-off year.

2004 Form 1099-Q Instructions — To Be Completed for CESA Distributions

3131 ☐ VOID ☐ CORRECTED

PAYER'S/TRUSTEE'S name, street address, city, state, ZIP code, and telephone number		1 Gross distribution $ 2 Earnings $	OMB No. 1545-1760 2004 Form 1099-Q	Payments From Qualified Education Programs (Under Sections 529 and 530)
PAYER'S/TRUSTEE'S Federal identification no.	RECIPIENT'S social security number	3 Basis $	4 Trustee-to-trustee transfer ☐	**Copy A For Internal Revenue Service Center** **File with Form 1096.** For Privacy Act and Paperwork Reduction Act Notice, see the **2004 General Instructions for Forms 1099, 1098, 5498, and W-2G.**
RECIPIENT'S name		5 Check one: • Qualified tuition program— Private ☐ or State ☐ • Coverdell ESA ☐	6 Check if the recipient is not the designated beneficiary ☐	
Street address (including apt. no.)				
City, state, and ZIP code				
Account number (optional)				

Form **1099-Q** Cat. No. 32223J Department of the Treasury - Internal Revenue Service

Do Not Cut or Separate Forms on This Page — Do Not Cut or Separate Forms on This Page

1. File Form 1099-Q, Payments from Qualified Education Programs (Under Sections 529 and 530), if you made a distribution from a Coverdell Education Savings Account (ESA) defined under section 530. Each and every distribution is to be reported.

2. **Do not** file Form 1099-Q for a change in the name of the designated beneficiary, as long as the new beneficiary is a member of the former beneficiary's family. Except for beneficiaries with special needs, the new beneficiary of a CESA must also be under age 30.

3. If you are required to file Form 1099-Q, you must provide a statement to the recipient. Furnish a copy of Form 1099-Q or an acceptable substitute statement to each recipient.

4. Insert the name and SSN of the designated beneficiary as the recipient.

5. You should file a separate Form 1099-Q for any trustee-to-trustee transfer.

6. If you are reporting a distribution from a Coverdell ESA that includes a returned contribution plus earnings, you should file two Forms 1099-Q — one to report the returned contribution plus earnings, and the other to report the distribution of the other part of the account.

7. Distribution Codes

For 2004, you may, but are not required, to include one of the following distribution codes in the blank box below boxes 5 and 6. You may abbreviate as needed. For example, for distribution code 1, you may enter "distr. code 1."

1— Distributions: Use this code for distributions (including transfers) to the accountholder and any direct payments to a qualified educational facility. However, use codes 2 or 3 for withdrawals of excess contributions.

2—Excess contributions plus earnings taxable in 2004: Use this code for withdrawals of excess Coverdell ESA Contributions and earnings unless Code 3 applies.

3—Excess contributions plus earnings taxable in 2004: Use this code for withdrawals of excess contributions from a Coverdell ESA. Advise payees, at the time the distribution is made, that the earnings are taxable in the year in which the contributions were made.

4—Disability: Use this code if you made distributions after the accountholder was disabled (see section 72(m)(7).

5—Death: Use this code for payments to a decedent's beneficiary, including an estate.

6—Prohibited Transaction: See section 530(e)

8. Method #1 to Complete Boxes 1-3

A. Box 1 — Gross Distributions

Gross distributions from a Coverdell ESA include a refund, a payment upon death or disability, or a withdrawal of excess contributions plus earnings.

B. Gross Distributions = Earnings + Basis

1. Box 2. Earnings

Use the earnings ratio described in Proposed Regulations section 1.529-3 and Notice 2001-81 to determine the earnings (or loss) on the gross distribution reported in box 1. Enter the earnings in box 2. If there is a loss and this is not the final year for distributions from the account or there are no earnings, enter zero in box 2. Enter a loss in box 2 only if this is the final year for distributions from the account. Any earnings are not subject to backup withholding.

2. Box 3. Basis

Enter basis in the gross distribution reported in box 1. The amount in box 3 must equal box 1 minus box 2.

For determining basis of a Coverdell ESA, you may rely on Notice 2001-81.

9. Method #2 — Complete box 1, but leave boxes 2 and 3 blank.

If earnings and basis are not reported for Coverdell ESA distributions, leave boxes 2 and 3 blank. Do not enter zero. Instead, you must report the fair market value (FMV) as of the end of the year in the blank box below boxes 5 and 6. Label the amount "FMV." See Notice 2003-53, 2003-33 I.R.B. 362, for more reporting requirements.

10. Special rules for withdrawal of an excess.

For Coverdell ESAs, if you are reporting earnings on a distribution of excess contributions, use the method for calculating the net income attributable to IRA contributions that are

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distributed as a returned contribution under Notice 2000-39, 2000-30 I.R.B. 132, and proposed Regulations section 1.408-11.

Use the blank box below boxes 5 and 6 to indicate that the amount in box 2 includes earnings on excess contributions. To meet this requirement, enter distribution code 2 or 3 (as applicable) in the blank box. See Notice 2003-53 for more information.

11. Box 4. Trustee-to-Trustee Transfer Checkbox

Check this box if the distribution was made directly from a CESA to another Coverdell ESA or a qualified tuition program.

In a trustee-to-trustee transfer between qualified education programs, the distributing program must provide the receiving trustee with a statement reporting the earnings portion of the distribution within 30 days of the distribution or by January 10, whichever is earlier. You must properly account for this in computing the earnings or (loss) reported in box 2 and the basis reported in box 3.

If you do not have records of whether a gross distribution from a Coverdell ESA made in 2004 was a trustee-to-trustee transfer, leave box 4 blank.

12. Box 5 Checkbox

You need to check the Coverdell ESA box to indicate that the distribution is from a CESA.

13. Box 6. Designated Beneficiary Checkbox

Check the box if the recipient is not the designated beneficiary under a qualified tuition program or a Coverdell ESA (see section 529(e)(1)).

Miscellaneous IRS Questions on the 10% Additional Tax on Early IRA Distributions

The IRS has provided the following 4 questions and answers concerning the 10% additional tax.

1. If we cash in an IRA account while in our thirties, what forms do we need to fill out?

You will need to file a Form 1040 and show the amount of withdrawal from your IRA. Since you took the withdrawal before reaching age 59½, unless you meet certain exceptions listed in Publication 590, "Individual Retirement Arrangements (IRAs)," you will need to pay an additional 10 percent tax on early distributions from qualified retirement plans that is reported on line 57 of Form 1040. You may need to complete Form 5329, "Additional Taxes on Qualified Plans (including IRAs) and Other Tax-Favored Accounts," and attach it to the tax return, if required. If you ever made nondeductible contributions to your IRA, you must complete Form 8606, "Nondeductible IRAs and Coverdell ESAs" and attach it to your return. Form 8606 is used to determine if the total amount of your distribution is tax free.

2. If we cash in an IRA account while in our thirties, when do we pay the taxes and penalties?

Because our tax system is a pay-as-you-go system, you may need to make an estimated tax payment by the due date for the quarter in which you received the distribution. When calculating your tax liability to determine whether you need to make an estimated tax payment, your total tax for the year should include the amount of the additional 10 percent tax on early distributions from qualified retirement plans, unless any exception applies.

You would calculate the tax on Form 1040-ES, "Estimated Tax for Individuals," and any 10 percent additional tax on early distributions from qualified retirement plans on Form 5329, "Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-favored Accounts." Any 10 percent additional tax would go on Form 1040-ES line 12, "other taxes," when completing the worksheet.

3. Can the 10% penalty for an early withdrawal from an IRA be deducted in the Adjusted Gross Income section of Form 1040 as a penalty on early withdrawal of savings?

No, the additional 10% tax on early distribution from qualified retirement plans you pay for a premature withdrawal of an IRA does not qualify as a penalty for withdrawal of a savings account.

4. If I can't withdraw funds penalty free from my 401(k) plan to purchase my first home, can I roll it over into an IRA and then withdraw that money to use as my down payment?

Yes, if you are receiving a distribution from a 401(k) that is eligible to roll over into an IRA and you meet all of the qualifications for an IRA distribution for a first-time home buyer. Your plan administrator is required to notify you before making a distribution from your 401(k) plan whether that distribution is eligible to be rolled over into an IRA. To see if you qualify for a distribution to be used as a first-time home buyer, refer to Publication 590, "Individual Retirement Arrangements (IRAs)."