THE Pension Digest

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ALSO IN THIS ISSUE –

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

Bankruptcy Bill Signed into Law — IRAs Treated Very Favorably

On April 20, 2005, President Bush signed into law the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. It contains provisions which protect from creditors, the IRA and other pension assets of individuals who file bankruptcy.

This final bankruptcy bill is good news for IRA accountholders, as their retirement plan assets are now more fully protected from creditors than under prior law. In general, IRA assets are protected, during bankruptcy proceedings, up to $1,000,000. The $1 million amount may be increased if the interests of justice so require. It appears that 100% of an IRA arising from a rollover contribution from certain qualified plans and section 403(b) plans will be 100% exempted from creditors, since such amounts do not count toward the $1 million. It also appears that any balance in a SEP-IRA or SIMPLE-IRA is 100% exempted from creditors, since such amounts also appear to not count toward the $1 million limit.

Under prior law, the exemption was limited to the extent necessary for the support of the debtor and his or her dependents. The law did not define what amount was necessary to support the debtor and his or her dependents. The new law is NOT limited to the amount needed to support the debtor. The new law allows any person to protect up to $1 million. The new law goes into effect on October 20, 2005, since this is 180 days after the date of enactment (April 20, 2005).

These IRA and pension exemptions under the new Bankruptcy Act are so favorable to the debtor that one can expect most debtors to elect to use the federal exemptions rather than the state exemptions in their bankruptcy filing.

IRAs — Domicile and the Location of IRA Assets Matters

Creditors will try to reach the assets within IRAs to satisfy a judgment debt. Debtors will act to make collection very difficult. The case of Susan J. Scott (a/k/a Susan Mahl), John Nicklas and H.D. Vest Financial Services vs Jim Aaron, No. 46A03-0307-CV-283 as decided in June of 2004 by a Court of Appeals in Indiana is illustrative.

Facts and the Trial Court Decision

A law firm obtained a judgment on September 9, 2001, in the amount of $1,039,834.91 plus attorney fees against Susan J. Mahl. While she had been the managing partner of the law firm, she had embezzled $750,000 from the firm. She had resigned from the law firm in 1999. The law firm was located in California. Susan Mahl moved to South Carolina and she changed her name to Susan Scott. Jim Aaron had been an attorney in this law firm. Mahl and Aaron were romantically involved from 1998-2001. The law firm assigned the judgment to Jim Aaron for collection purposes.

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In 2000 Susan Mahl had opened IRAs with John Nicklas who had his office in Laporte, Indiana. The IRAs were set-up using the names of Jeanne Ginther and Susan Mahl for the benefit of Susan Scott. The IRA funds were invested with H.D. Vest Financial Services. Jeanne Ginther was Susan Mahl's mother. The sole designated beneficiary of this IRA was Susan Mahl. Mr. Aaron had discovered what Susan Mahl had done. She had told him she was changing her name for the purposes of preventing her former partners from executing against her assets. Mr. Aaron went to Indiana to domesticate the California judgement and to enjoin Mahl from removing or diminishing the value of the assets. The Indiana Court issued an injunction against Mahl, Nicklas and H.D. Vest Financial Services. Jeanne Ginther died on June 22, 2000. In violation of the court order, Mahl did transfer funds from the Indiana IRA to an IRA located in South Carolina.

The Indiana trial court granted Aaron's request for a summary judgment in the amount of $1,122,389.63 plus costs. In addition, the Indiana trial court ruled: (1) the disposition of the IRA is governed by Indiana law; (2) Mahl is not entitled to use the exemption under Indiana law which states that IRA funds are exempt from creditors; (3) the IRA funds located in South Carolina could not be ordered returned to Indiana; (4) Mahl was in contempt of a court order and punishment would be set unless she returned the IRA funds to Indiana; and (5) the IRA funds in South Carolina could not be deeded to Mr. Aaron.

The Appellate Court Decision

The Appellate court ruled that Mahl could not exempt the IRA assets from Aaron because she was not domiciled in Indiana. She was domiciled in South Carolina. See the following statute. It clearly applies only to a judgment debtor domiciled in Indiana.

The appellate court also ruled that the Full Faith and Credit Clause of the U.S. Constitution was not violated even though Aaron could reach the assets in Indiana when he could not have reached them in California since Mahl would have apparently been entitled to the exemption provided by California law. The appellate court ruled that although full faith and credit shall be given in each state to the public acts, records, and judicial proceedings of every other state, this does not mean that a state must adopt the practices of other states regarding the time, manner, and mechanisms for enforcing judgments. The court found the difference between the two exemption statutes to be "enforcement" in nature and thus they could be different.

Indiana Code section 34-55-10-2(b)(6) provides:

(b) The following property of a judgment debtor domiciled in Indiana is not subject to levy or sale on execution or any other final process from a court, for a judgment founded upon an express or implied contract or a tort claim:

(6) An interest, whether vested or not, that the judgment debtor has in a retirement plan to the extent of:

(A) contributions, or portions of contributions, that were made to the retirement plan;

- (I) by or on behalf of the debtor; and
- (II) which were not subject to federal income taxation to the debtor at the time of the contribution;

(B) earnings on contributions made under clause (A) that are not subject to federal income taxation at the time of the judgment; and

(C) rollovers of contributions made under clause (A) that are not subject to federal income taxation at the time of judgment.

For purposes of Subsection (6), Retirement plan includes:

(1) a stock bonus, a pension, a profit sharing, an annuity, or a similar plan or arrangement, including a retirement plan for self-employed individuals or a simplified employee pension plan;

(2) a government or church retirement plan or contract; or

(3) an individual retirement annuity or individual retirement account that is intended in good faith to qualify as a retirement plan under applicable provisions of the Internal Revenue Code of 1986 as amended.

We choose this case to illustrate that the domicile of an IRA accountholder is very important, as is the location of the IRA funds. Most states will apply the rule that when determining whether personal property is subject to execution, a court will normally look to the law in the state in which the property is located at the time the

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debt arose.

Both an IRA custodian and the IRA accountholder want to understand to what degree, if at all, an IRA is exempt from creditors. In this case, by moving from California, Susan Mahl gave up the exemption she would have been entitled to under California law.

One also wonders if the Internal Revenue Service was ever paid the proper amount of taxes by Ms. Mahl. The purported rollovers into an IRA established for her mother violated numerous tax rules and did not qualify to be rolled over. It would have been an excess contribution.

One also wonders to what degree a California court would have exempted the funds in the IRA. A court may well find that a debtor does not need a good portion of the funds within an IRA for his or her support. There is little law on this subject — the amount of funds needed to support the IRA accountholder.

Errata

There is an error in the April 2004 newsletter article, "Calculating a Beneficiary's" RMD When The IRA Owner Died Prior 2003." The first sentence of the seventh paragraph should have read — The IRS chose the second alternative. As written, it indicated the IRS chose the third alterative. Please indicate somehow on your April 2004 version that there was an error and the June Newsletter should be referred to. A portion of the article is set forth immediately and on the next page.

Correction to April, 2005 Article

Calculating a Beneficiary's RMD when the IRA Owner Died Prior to 2003

How is the RMD calculated with respect to a non-spouse beneficiary when the IRA accountholder died prior to 2003, and died after their required beginning date?

For discussion purposes, it is assumed that an accountholder died in 1994, at age 76. The beneficiary was also age 76 in 1994. How do the IRA custodian and the beneficiary calculate the RMD amount for the beneficiary for 2002 and subsequent years?

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special 60-day rollover waiver program, and allow the funds to be rolled into another Roth IRA. It would be the accountholder's decision as to whether or not this is worthwhile. The IRS filing fee is $90, plus a fee to prepare the filing of $100 - $300.

Summary: An IRA custodian wants to avoid the above situation. If it does happen, you may wish to talk with the bank's attorney to receive guidance as to how to resolve the situation with the accountholder. Your institution may well be liable for the harm suffered by the accountholder. The accountholder has suffered a loss. It may not be totally clear in terms of dollars as to the exact amount of harm she has suffered, but she has been harmed. She has been forced to take a distribution from a Roth IRA which she otherwise would not have taken. She has lost the right to earn tax-free income for the rest of her life with respect to her contribution amount of $2,000.

Calculating a Beneficiary's RMD when the IRA Owner Died Prior to 2003

How is the RMD calculated with respect to a non-spouse beneficiary when the IRA accountholder died prior to 2003, and died after their required beginning date?

For discussion purposes, it is assumed that an accountholder died in 1994, at age 76. The beneficiary was also age 76 in 1994. How do the IRA custodian and the beneficiary calculate the RMD amount for the beneficiary for 2002 and subsequent years?

In writing the final regulation, presumably the IRS considered the following three alternatives for calculating the RMD for the beneficiary in the situation where the IRA accountholder died many years before the RMD rules were adopted.

The first alternative would have been to continue the single life-distribution schedule which the IRA accountholder had been using. See column #3 of the chart below. Under the proposed regulation, the factor would have been 16.0 in 1988, when the IRA accountholder would have attained both age 70 and 70½.

The second alternative would have been to redetermine the life expectancy using the new rules and tables and then apply them as if these rules had been in effect when the IRA owner died. The practical consequence of such a rule would be that the beneficiary would receive the benefit of using the new, longer life-expectancy factors. See column #4 of the chart below. The beneficiary would really benefit if the life-expectancy factor were determined in 2002, and not 1995 (i.e. the year after the year the accountholder died).

The third alternative would have been to redetermine the life-expectancy factor in 2002, by using the then-current age of the beneficiary and using the new life-expectancy factor from the "new" Single Life Table. See column #5 of the chart below.

#1 Year	#2 Age of Beneficiary	#3 Life Expectancy Factor	#4 Life Expectancy Factor	#5 Life Expectancy Factor
1994	76	10.0	N/A	N/A
1995	77	9.0	11.1	N/A
1996	78	8.0	10.1	N/A
1997	79	7.0	9.1	N/A
1998	80	6.0	8.1	N/A
1999	81	5.0	7.1	N/A
2000	82	4.0	6.1	N/A
2001	83	3.0	5.1	N/A
2002	84	2.0	4.1	8.1
2003	85	All out	3.1	7.1
2004	86	N/A	2.1	6.1
2005	87	N/A	1.1	5.1
2006	88	N/A	All out	4.1

The IRS chose the third alternative. The regulation provides that the new rules of the final regulation must be used for calendar years beginning on or after January 1, 2003, even if the IRA accountholder died prior to January 1, 2003. An IRA custodian was permitted to use these new rules for 2001 and 2002, if it so chose. There must be a redetermination of who is the beneficiary or who are the beneficiaries for RMD purposes as of September 30 of the year following the IRA accountholder's death, and the applicable distri-

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bution period must be reconstructed for purposes of determining the amount required to be distributed for 2003 and subsequent years.

In plain English, the divisors as set forth in column #4 are to be used, and it would be incorrect to use the divisors set forth in columns #3 or #5. Note, the use of column #3 would mean the beneficiary will have taken out more than he or she was required to. The use of column #5 would mean the beneficiary would have taken out less than he or she was required to, and the 50% tax would be owed.

The applicable distribution period is determined by using the beneficiary's age as of the beneficiary's birthday in the calendar year immediately following the year of the IRA accountholder's death. For subsequent years, this initial factor is reduced by one for each subsequent year. Since the IRA accountholder died in 1994, the age of the beneficiary is determined in 1995 (age 77), and, therefore, the initial factor is 12.1, and will follow the schedule of 11.1, 10.1, 9.1, etc., for subsequent years.

The old and new Single Life Tables, as set forth below, illustrate the improvement in life expectancies.

Age	Old Table	New Table
70	16.0	17.0
71	15.3	16.3
72	14.6	15.5
73	13.9	14.8
74	13.2	14.1
75	12.5	13.4
76	11.9	12.7
77	11.2	12.1
78	10.6	11.4
79	10.0	10.8
80	9.5	10.2
81	8.9	9.7
82	8.4	9.1
83	7.9	8.6
84	7.4	8.1
85	6.9	7.6
86	6.5	7.1
87	6.1	6.7
88	5.7	6.3
89	5.3	5.9
90	5.0	5.5
91	4.7	5.2
92	4.4	4.9
93	4.1	4.6
94	3.9	4.3
95	3.7	4.1
96	3.4	3.8
97	3.2	3.6
98	3.0	3.4
99	2.8	3.1
100	2.7	2.9
101	2.5	2.7
102	2.3	2.5
103	2.1	2.3
104	1.9	2.1
105	1.8	1.9
106	1.6	1.7
107	1.4	1.5
108	1.3	1.4
109	1.1	1.2
110	1.0	1.1
111	.9	1.0
112	.8	1.0
113	.7	1.0
114	.6	1.0
115	.5	1.0

A Large SIMPLE-IRA Contribution

Question: Was it permissible for a person to make a contribution of $21,000 to her SIMPLE-IRA for 2004?

Answer: Yes. If the individual was over age 50 as of 12-31-04, then she was entitled to make an elective deferral of $10,500 ($9,000 + $1,500). She was also entitled to receive a matching contribution from her employer (i.e. herself) equal to the amount of her elective deferrals (i.e. $10,500), but no more than 3% of her compensation or net earnings. If her compensation was sufficiently large, then the matching contribution would also be $10,500. The total contribution amount then would be $21,000.

For a person who is self-emplyed, his or her net earnings from self-employment for the year is the amount from line 4 of Schedule A or line 6 of schedule B (i.e. net profits x .9235) of Schedule SE before subtracting any SIMPLE contributions made on his or her behalf. Net profits of $378,993 or more would substantiate a matching contribution of $10,500. $378,993 x .9235 x 3% = $10,500.

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This was the question posed in the article with the same title published in the April 2005 Pension Digest—shown on the previous page.

The article was correct in its entirety, except for one key word. After discussing the three methods the IRS may have considered in handling the situation mentioned above, CWF inadvertently stated that the IRS chose the third alternative when, in fact, it should have been the second alternative.

For a copy of the corrected article, please go to our web site at: www.pension-specialists.com and download the pdf file. Or please feel free to give us a call at 800-346-3961, and we will fax or mail a copy to you.

IRA Fees

IRS guidance on IRA fees is not as extensive as one would think. The IRS has expressly discussed whether or not trustee fees and broker fees must be considered to be "reportable" contributions so that they count toward the contribution limit.

With respect to trustees' administrative fees, the IRS ruled in 1984, in Revenue Ruling 84-146, that such fees are not subject to the contribution limit, and that amounts paid by the IRA owner for trustee fees will be deductible under Code section 212, to the extent such fees are ordinary and necessary, but that capital expenditures and disguised IRA contributions will not be deductible.

With respect to brokers' commissions paid in connection with a traditional IRA, in 1986 in revenue ruling 86-142, the IRS ruled that such commission fees or expenses are subject to the contribution limit and they are not deductible under section 212. The IRS ruled that brokers' fees were not recurring administrative or overhead expenses incurred in connection with the maintenance of the IRA. Rather, brokers' commissions were intrinsic to the value of the IRA assets (i.e. part of the cost of the purchase and the cost of the sale).

What about fees for establishing the IRA, transfer fees, close-out fees, etc.?

The IRS has never given direct guidance on such fees. CWF is unaware of any prior letter rulings asking for guidance about such fees. Many of these other fees were more "transactional " in nature, rather than being "administrative" in nature. I believe most people read Revenue Ruling 86-142 as meaning that the IRS was not favorably inclined to treat other fees or expenses as administrative expenses.

CWF wrote its IRA plan document to state that the IRA custodian has the authority to withdraw any and all fees or expenses from the IRA. This is clearly easiest for the IRA custodian. It is not necessarily what is best for the IRA owner. The CWF document does state that the IRA owner has the right to pay the IRA custodian the amount of any administrative fee, but the IRA custodian is not required to remind him or her that they have this right. The current CWF document does not grant the right to the individual to contribute any fee amounts other than an annual administrative fee. As mentioned below, the IRA custodian could be assessed $50 per IRA, if the IRS would enforce the position that such payment of fees had to be reported as annual contributions.

The fee area is certainly a "be careful" area. If a person pays a fee in addition to making his or her maximum contribution for the year, and then the IRS would rule that such fee is one which must be counted against the contribution limit, then an excess contribution situation would exist, and there would be the related 6% excise tax issue. An IRA owner may well try to argue that the IRA custodian was negligent by allowing a person to contribute such fees and not count them toward the contribution limit. There could be fines and penalties for an IRA custodian if it had prepared its 5498 forms incorrectly, since it did not add such fees into the appropriate contribution boxes.

A very recent 2005 IRS private letter ruling (PLR200507021) will again make the fee subject a very hot topic. In this PLR, the IRS ruled that a flat fee based on a percentage of assets could be paid by the individual with personal funds (i.e. the IRA would not be required to pay this fee) and such payment would not count toward the contribution limit. Presumably, such a flat fee charged by a securities firm is very similar to the fee charged by a trustee.

The IRS' ruling was very favorable for the IRA owners who have their IRAs with the securities firm, as discussed below. By not having to have their IRAs pay the annual fee, these IRA accountholders will be able to accumulate more wealth in their traditional IRAs and Roth IRAs.

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The requester of the private letter ruling is a company which is a securities broker/dealer and an investment advisor. It provides a variety of services to its clients, including investment banking, securities brokerage, trading, investment management, retirement planning, estate planning and trust services. The company created various programs which combined its investment advisory services with its securities trade services. Such programs would be offered to its IRA clients. The company proposed charging a single fee (a "wrap fee"). The fee is based on the percentage of the assets, and it bears no relation to the number of trades the IRA accountholder causes the custodian to execute.

The current IRS is certainly not the old IRS. The IRS ruled that "Such fees assessed by Company M for its services with respect to Portfolios A, B, C, D, and E are recurring administrative or overhead expenses incurred in connection with the maintenance of client's IRAs and/or Roth IRAs." Therefore, the payment of such wrap fees by the traditional IRA accountholder and/or the Roth IRA accountholder will not be deemed to be contributions to such clients' traditional IRAs or Roth IRAs.

Of course, the letter ruling states that it cannot be cited as precedence, as it is directed only to the taxpayer who requested it. It should be noted that the requester had first requested this ruling on January 25, 2001.

On a subject this important, the IRS should have chosen to issue a Revenue Ruling. To the extent they can, any and all IRA owners would like to take advantage of the IRS' apparent new position on fees. A taxpayer may cite a Revenue Ruling as precedence. By choosing not to issue a Revenue Ruling, the IRS is either choosing to favor this one requester, or it is keeping its options open so that it may change its position if there would be too much "political flack."

HSA Fees

In Question and Answer 71 of Notice 2004-50, the IRS expressly states that administration and account maintenance fees may be paid directly by the HSA account owner or an employer, and such payment will NOT be considered contributions to the HSA. In Question and Answer 69 of Notice 2004-50, the IRS states that payment of the maintenance fee from the HSA does not require this amount to be treated as a reportable or taxable distribution. In Question and Answer 70 of Notice 2004-50, the IRS states that the authorized withdrawal of the maintenance fee by the HSA does not mean the contribution limit is increased by such maintenance fee amount. In essence, Q/A69-71 states that the existing IRA rules will apply to HSAs.

Although some IRA rules pertaining to fees are not clearly stated, it is clear that "administrative fees" do not count towards the contribution limit. This is as true for HSAs as it is for IRAs. The most conservative approach would be to have an annual administrative fee. An individual could pay for the annual administrative fee separately, and, therefore, this fee would not reduce the HSA account balance. The HSA custodian would need to account for the receipt of the fee, but would not need to report it on the Form 5498-SA.

Are fees to establish the HSA and close out the HSA considered administrative fees? CWF believes an argument could be made that such fees are administrative fees. On the other hand, it could be argued that such fees are intrinsic to the establishment and termination of the HSA. Until the IRS issues further guidance, CWF would not recommend that an HSA custodian allow an HSA owner to pay for these fees. We believe such fees should be paid by the HSA. If a financial institution would want CWF to write an HSA plan document treating such fees as "administrative," we would be willing to do so on the condition that the financial institution would assume responsibility if the IRS would rule otherwise.

Many HSA custodians are using checking accounts which have monthly or quarterly fees. We believe such fees are "administrative," and the HSA account owner may pay such fees separately.

October 1, 2005 — Deadline to Establish a New Safe Harbor 401(k) Plan for 2005

As discussed in our May 2003 newsletter, adoption of a safe harbor 401(k) plan can be very advantageous to a business owner. This is particularly true in the case of a small business, or in the case of a family-owned-and-operated business, since these owners face significant challenges when trying to realize tax benefits from sponsoring or maintaining a tax-preferred pension program. This is the result of IRS tax laws and regulations which favor the rank and file employees.

Since the article was published, we have had a number of clients requesting assistance in the establishment of a safe harbor 401(k) plan. The adoption of such a plan dramatically increases a business owner's ability to make the most of retirement savings opportunities.

Just last month, we had a client, a physician, inform us that she would like to accumulate more money in her retirement account, but felt that her existing retirement plan limited her ability to accomplish this goal. In our example, we will refer to our physician/client as Dr. Jan Smith. For ease of illustration, all numbers have been rounded to the nearest hundred. Dr. Smith is 51 years old and earns over $200,000 per year. Her practice sponsors a money purchase plan (or it could be a SEP or a profit sharing plan). Each employee is allocated 4% of his or her compensation.

In 2004, Dr. Smith received a contribution of $8,000, while three rank and file participants received contributions totaling $2,700.

In order to improve Dr. Smith's situation, CWF would suggest adopting a 401(k) safe harbor plan. The current plan which Dr. Smith sponsors would be terminated. Unlike most 401(k) plans that are subject to an ADP (Actual Deferral Percentage) test that severely limits the amount an owner can defer into the plan, utilization of a 401(k) safe-harbor feature guarantees that a business owner can defer the maximum amount permitted by the IRS.

If a 401(k) safe harbor plan had been in effect, Dr. Smith could have deferred the limit of $13,000 for 2004, plus an additional $3,000, since she was 50 or older in 2004. Assuming an employer matching contribution equal to 100% of a participant's elective deferrals, with no contribution made with respect to deferrals in excess of 4% of a participant's compensation, Dr. Smith would have received a matching contribution of $8,000 ($200,000 x 4%). Under this scenario, Dr. Smith has increased her annual contribution for 2004 to $24,000 ($13,000 + $3,000 + $8,000), compared to $8,000 using her previous plan. This represents an increase of 200%, and clearly helps Dr. Smith achieve her retirement planning goals. With this type of plan design, the employer's contribution to the rank and file employees would have totaled $3,200, compared to the original contribution of $2,700 — an increase of only $500 (assuming all participants contributed 4% or more of their salary to the plan)

In the example above, not only can Dr. Smith reduce her tax bill by more than $4,800 ($16,000 x assumed marginal rate of 30%), but her employees would be able to accumulate more money in their retirement accounts as well, as they are able to defer a portion of their salary into the plan — a feature that is not allowed in the existing plan. The safe harbor 401(k) plan allows Dr. Jan Smith to electively defer the maximum amount while only being required to make matching contributions of 4% of compensation for her employees.

CWF believes that the adoption of a safe harbor 401(k) plan as outlined above provides a compelling way to help the family business owner direct retirement plan spending toward family members, and also make it easier for all other employees to reach their retirement plan goals.

If you are interested in learning more about 401(k) safe harbor plans, or would like to explore other alternatives to meet your client's financial goals, please contact one of our consultants. Current sponsors of a profit sharing plan, or employers that have no existing retirement plan, have until October 1, 2005, to adopt a safe-harbor plan for 2005.

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Can 401(k) Funds Be Directly Rolled Over to a Roth IRA?

We have been asked this question numerous times. Financial institutions do not always realize or understand that it IS NOT PERMISSIBLE to roll over 401(k) funds to a Roth IRA.

A direct rollover check which is issued by a 401(k) plan should be made to the receiving financial institution as follows: "ABC Bank for benefit of John Doe's traditional IRA." If the check was made out as "ABC Bank for benefit of John Doe," then it is not clear what should be done with these funds. If the bank would let the individual put the funds in a Roth IRA, the funds would escape taxation. Remember, the 401(k) plan will prepare the Form 1099-R showing the funds were directly rolled over, and thus the IRS would think they were nontaxable. Because it is the duty of the individual to comply with current tax law, they should know that 401(k) funds cannot be rolled over to a Roth IRA. Trying to make such a rollover to avoid taxation could be considered theft or fraud. Although the liability for an impermissible rollover ultimately lies with the individual, they could possibly blame the bank for not knowing that the transaction was unauthorized and impermissible.

It is permissible for 401(k) funds to be directly rolled over or rolled over to a traditional IRA. A distribution which is rolled over is not subject to taxation. The funds in the traditional IRA could then be converted to a Roth IRA (a Roth conversion). This is a taxable event. An individual would have to decide whether or not it is in their best interest to pay normal income tax on the distribution from the traditional IRA to have the benefit of the interest growing tax free upon its conversion to a Roth IRA.

Congress is considering a law change to permit the direct rollover of 401(k) funds to a Roth IRA. However, such a law change will obviously require changes in the IRS reporting process, since such a conversion of 401(k) funds into Roth funds will require the individual to include the 401(k) funds in his or her income and pay the related taxes.

Your institution needs to always be aware of the source of the funds in a direct rollover situation, and needs to make certain the check is made out properly and the funds are handled correctly.

Rollover of Coverdell ESA to a Section 529 Plan — Is it Permissible?

It is permissible to roll over funds from a Coverdell ESA (CESA) to a Section 529 Plan. In most cases, the designated beneficiary of a CESA is a minor. How will the distribution from the CESA be reported? This distribution is obviously not being used to pay current educational expenses.

The financial institution will report the distribution as a normal CESA distribution on the Form 1099-Q. It will be up to the individual to inform the IRS as to why this distribution of funds is not taxable. This would normally require the child to file a tax return. However, the IRS has a special provision for minors who have not yet reached age 14. The special rule is that the parents may include the child's CESA distribution on their 1040 tax return. For 2005 tax purposes, a child born prior to 1/1/91 is considered to be 14 at the end of 2005; a child born 1/1/91 or later, is not considered to be 14 at the end of 2005.

CWF suggests the CESA rollover distribution be shown as follows. Line 21 of the 1040 (other income not reported elsewhere) would be used. On the explanation line of Line 21, write "CESA Rollover Gross amount of $_________." On the number line of Line 21, write "0." This should be sufficient for the IRS to realize that it is rollover, and, therefore, no amount is taxable. However, we suggest an individual confirm this method with their tax advisor. The parents would also need to complete and submit IRS Form 8814 with their tax return.

How to Report the 50% Tax on a Late RMD Distribution

The RMD rule states that if an RMD is not timely distributed, the accountholder owes a 50% excise tax on the amount which was required to be distributed, but was not. How is this additional tax reported by the accountholder?

Example: An IRA accountholder, Eric, turned 70½ in 2004, and, therefore, was required to take an RMD for 2004 ($2,000). Because this was his first RMD, the deadline for taking it was 4/1/05. Eric did not take his RMD by this deadline; he now owes a 50% tax on this RMD amount.

Because the due date to take the RMD was 4/1/05, Eric will owe the 50% additional tax for 2005, not 2004. Therefore, he will need to complete a 2005 Form 5329, (the Name and Address section and Section VIII). These sections of the form are reproduced below. On line 44, he will list the total amount of his 2004 RMD ($2,000); on line 45, he will list the amount which was timely distributed, if any (in this case, "0"); on line 46, he will list the amount which was NOT timely distributed ($2,000); and on line 47, he will list 50% of line 46 ($1,000 — this is the amount of tax owed). He will then carry the $1,000 amount on line 47, to line 59 of his 2005 Form 1040.

Eric's second RMD amount must be taken by 12/31/05. Eric must be aware that if his 2005 RMD is not taken by 12/31/05, the amount not timely distributed will also be taxable on his 2005 income tax return. This will hold true for all future years — any RMD amount not taken by 12/31 each year will be taxable in the year for which the RMD was required, because for all years except the first RMD year, the deadline to take an RMD is 12/31 of the year in question.

Form **5329**

Department of the Treasury
Internal Revenue Service (99)

Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts

▶ **Attach to Form 1040.**

▶ **See separate instructions.**

OMB No. 1545-0203

2005

Attachment Sequence No. **29**

Name of individual subject to additional tax. If married filing jointly, see instructions.	**Your social security number**
Fill in Your Address Only If You Are Filing This Form by Itself and Not With Your Tax Return — Home address (number and street), or P.O. box if mail is not delivered to your home	Apt. no.
City, town or post office, state, and ZIP code	If this is an amended return, check here ▶ ☐

Part VIII **Additional Tax on Excess Accumulation in Qualified Retirement Plans (Including IRAs)**
Complete this part if you did not receive the minimum required distribution from your qualified retirement plan.

44	Minimum required distribution for 2005 (see instructions)	44		
45	Amount actually distributed to you in 2005	45		
46	Subtract line 45 from line 44. If zero or less, enter -0-	46		
47	**Additional tax.** Enter 50% (.50) of line 46. Include this amount on Form 1040, line 59	47		

Signature. Complete **only** if you are filing this form by itself and not with your tax return.