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

$250 to $500 Million Sought from H&R Block, Inc. for Fraudulent Marketing of IRAs

The state of New York has reached the conclusion that H&R Block, Inc. has done such a poor job of marketing and explaining its IRA products and services that it commenced a civil suit alleging fraud and deceptive acts.

On March 15, 2006, Eliot Spitzer, Attorney General of the state of New York, commenced a civil law suit against H&R Block, Inc. The case title is, THE PEOPLE OF THE STATE OF NEW YORK, by ELIOT SPITZER, Attorney General of the state of New York, Plaintiff, vs. H&R Block, Inc. and H&R Block Financial Advisors, Inc., Defendants.

The state of New York is alleging: (1) H&R Block, Inc. has been engaged in fraudulent acts which they continue to repeat in violation of Executive Law section 63(12); (2) H&R Block, Inc. has engaged in deceptive acts and practices as prohibited by New York law section 349; (3) H&R Block, Inc. has engaged in actual or constructive fraud under the common law of the state of New York and (4) H&R Block, Inc. has breached its fiduciary duty under New York common law.

The relief being sought is: (1) pay civil damages in an amount no less than $250 million; (2) disgorge all profits related to the fraudulent IRA activities; (3) pay the actual damages incurred by each customer or make restitution to such individuals; (4) pay punitive damages; (5) issue a permanent injunction so that H&R Block, Inc. will stop their fraudulent activities; and (6) pay the state's costs for bringing this action, including the state's legal fees.

We have written this article based on the information set forth in the Complaint and the related exhibits. This information has been prepared by the state of New York. H&R Block will present its side of the story when it prepares its Response.

We have chosen to make this lawsuit our lead article. It is extraordinary when a state Attorney General commences a law suit against a major corporation alleging fraud in the offering of IRA products and services. Most state laws provide the attorney general with very broad powers under the general business laws to fight fraud and deceptive acts. How deficient do marketing materials and disclosures have to be to be considered fraudulent or deceptive?

Who supervises IRA custodians and IRA trustees?

Up until now, it has been generally believed that the IRS and the appropriate regulator of a bank, credit union, insurance company, or brokerage company are responsible for supervising the IRA custodian or trustee. In the last 20 years, audits of IRAs by the IRS and the financial institution regulators have decreased. The IRS has certainly had other priorities. The state of New York has decided it will act when it believes

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the IRA custodian is violating state law, even though the IRS and other regulators have not acted. It is well known that Attorney General Spitzer is a candidate for Governor of New York. The filing of this case during peak tax time was not a coincidence.

Tax Returns & IRA Contributions go Hand-in-Hand

H&R Block, Inc. prepares federal (and state) income tax returns for mostly low and moderate income individuals and families. It is the nation's largest tax preparation company, with 10,000 offices. It prepares an average of 15 million tax returns per year. When a person goes to a tax preparer, the person's primary goal is to have his or her tax return prepared correctly. However, because of the way the federal income tax laws have been written, a person may still take some actions which will lower his or her tax liability with respect to the tax return being prepared. For example, when one goes to see his or her tax preparer in March of 2006 to have his or her 2005 tax return prepared, the person may still be able to make an IRA contribution for the prior year, which will lower his or her 2005 tax liability. The tax preparer certainly has the duty to make this known to the individual. IRAs are greatly impacted by federal tax laws. Because of the ability of many taxpayers to claim a tax deduction for their contribution (i.e. which lowers the amount of tax one owes), it was a natural that H&R Block would consider offering some sort of IRA products and services. One of the duties of a tax preparer is to suggest methods for a person to take to lower his or her tax liability both for the current tax year and for subsequent years. H&R Block, Inc. decided that it wanted those customers who decided to make an IRA contribution to set up the IRA with a business unit which they controlled, rather than sending their tax customers to the local bank, savings and loan, or credit union to establish an IRA.

H&R Block's IRA Services and Related Statistics

H&R Block, Inc. started to offer its IRA products and services in 2001. This means that most of the IRAs that were opened from January 1, 2001, to April 15, 2001, would have been for tax/IRA year 2000. Almost all contributions made from April 16, 2001, to December 31, 2001, would have been for tax/IRA year 2001. It does not appear that H&R Block prepared many internal reports on a tax/IRA-year basis. Their reports were run on a calendar-year basis. The following chart was prepared to illustrate the fact that contributions made in a given year could have been made for two different IRA/tax years:

Calendar Year	Contribution Could Have Been for Either or Both of Two Different Tax/IRA Years
2001	2000 and/or 2001
2002	2001 and/or 2002
2003	2002 and/or 2003
2004	2003 and/or 2004
2005	2004 and/or 2005
2006	2005 and/or 2006

The Four (4) Claims of Fraud by New York State

The state's argument is — a disclosure which does not cover what it must, amounts to fraud. The state argues that the disclosure must set forth both the positives and the negatives of what is being sold.

Claim #1. The Steering Claim

1. "H&R Block abuses its relationship of trust by **steering** its customers into an unsuitable, fraudulently marketed, poorly performing, fee-ridden 'retirement vehicle' called the Express IRA."

The fact is, the contribution or "take" rate for H&R Block tax customers was only 1.8%. The following chart shows the IRAs which were established nationwide from 2001-2005.

2001	23,967
2002	145,972
2003	110,383
2004	147,009
2005	255,860
Totals	683,191

CWF's Comment. When less than 2% of all tax customers made an IRA contribution to an Express IRA, it will be interesting to see if New York State can prove that H&R Block employees were "steering" their customers. There is other information showing that H&R employees either did not want to sell this product, or they did not know enough to do a good job of selling

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Express IRAs. It appears, they were quite inept at selling the Express IRA. Since approximately 9% of all U.S. taxpayers made an IRA contribution each year, it does not appear that H&R Block personnel did a very good job of steering its customers.

Claim #2. Failure to Tell Customers That the Express IRA Was Not Right for Them

The state of New York is arguing that because of the special fiduciary relationship of being an IRA custodian, the employees of H&R Block Inc., have the duty to tell more customers than they did, that the Express IRA is not right for them. The state argues that the disclosures do not adequately warn these low- to moderate-income customers that an Express IRA is inappropriate for short-term savings needs. It appears New York State is arguing that H&R Block, Inc. must try to determine if the individual may need the money soon, then H&R Block, Inc. must tell them that an IRA investment is inappropriate. The state is not convinced that when a person opens an IRA, he or she understands that an Express IRA is a retirement account and that it generally is to be used for long-term saving purposes rather than short-term savings purposes.

The state argues that, at a minimum, the H&R Block, Inc. disclosure needs to convey this message, as well as the various fees and tax consequences that would be imposed for an "early" withdrawal. The state has estimated that H&R Block customers have incurred $6 million in tax penalties for these early withdrawals. The state of New York believes H&R Block should bear this cost because of its inadequate disclosures.

The state even suggests in the Complaint that the disclosure must inform the client that his or her contribution to the Express IRA may make them ineligible for certain governmental assistance programs (federal and state), and failure to disclose such effects means the disclosure is inadequate, and thus would be fraudulent.

CWF's Comment

It will be interesting to see how New York State will prove this claim. It appears the state has the expectation that the tax preparers of H&R Block must be prepared to make the determination for an individual as to whether or not an IRA contribution is right for them or not right for them. It seems to us this goes past the role of being the tax preparer. Maybe the explanation should be, "based on guidance as furnished by the state of New York, you appear to be too poor to have an IRA, and the odds are great that you will need to use the funds within the next 24 months; therefore, we are not going to let you establish this IRA."

Claim #3. Failure to Disclose the Account's Negative Rate of Return

The state of New York is arguing that in order to comply with the antifraud rules, there must be a clear disclosure that this account pays a very low rate of interest, there is actually a negative return when the fees are considered, and that this account, more often than not, will shrink over time. The assessment of fees means the depositor's principal, over time, will decrease, unless he or she makes large or repeated deposits. The state of New York has also argued that H&R Block has the duty to explain that the interest rate being paid is lower than the rate of inflation. The marketing and IRA plan document materials do not emphasize this negative return and low rate of earnings, and thus amount to fraud or deception under New York law.

CWF's Comment. Many financial institutions will be surprised to learn that they have the duty to expressly set forth a statement in their marketing materials and other disclosures that the amount of interest they are paying is less than the rate of inflation.

Many financial institutions will also be surprised to learn that they have the express duty to explain that because of various fees being assessed the account, the account will have a negative rate of return and will most likely "shrink" over time.

The state of New York intentionally limits its discussion of the Saver's Tax Credit. That is, the state argues that the fees must be considered in determining whether the IRA contribution should be made, but the impact of the Saver's Credit should not be as important a factor as the interest rate. The reality is different. The Saver's Credit is extremely important. In many cases, a person should obtain a loan, if necessary, just so he or she can receive the benefit of the tax credit. There is one sentence in the complaint which illustrates the state's viewpoint. "In enacting the Federal Savings

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Credit, Congress could not have intended to encourage savings through a vehicle where the adviser takes more in fees than the client earns in interest." These people must live in ivory towers. Common sense tells one to give little heed to the interest rate and take the tax credit. The tax credit makes the taxpayer money. For example, by contributing $300 to an IRA, an individual makes $150. Or, by contributing $1,000 to an IRA, an individual makes $500. Most people would be willing to pay someone $50 - $100 to earn $300 or $500 they otherwise don't know how to obtain.

H&R Block foresaw, in 2001, that the Saver's Credit recently enacted into law would benefit may of its tax customers. The Saver's Credit was initially authorized for tax years 2002-2006. The specific intent of this law change was to give a tax benefit to low- and moderate-income taxpayers, and to encourage them to save for retirement by making contributions to a 401(k) plan in which they participate or into their IRA. The Saver's Tax Credit is certainly a very valuable tax-planning tool for those with low and moderate incomes.

Claim #4. Failure to Disclose the Numerous Fees

H&R Block fails to disclose the full extent of the fees associated with the Express IRA as New York law requires. It is alleged that a complete fee schedule is not furnished to the individual until weeks after he or she signed the Express IRA application. The state of New York alleges that the practice of furnishing the IRA Disclosure Statement 2-3 weeks later is deceptive. Even then, the fee schedule is confusing. Set forth below is the Express IRA fee schedule:

* Account Opening	$ 0.00
* Recontribution	$ 0.00
** Annual Account Maintenance	$ 10.00
Account Termination	$ 25.00
Returned Check/ACH	$ 20.00
Statement Duplicate Copy	$ 3.00
Wire Transfer Out	$ 25.00

* An account may be charged a $15 account opening or $15 recontribution fee if none of the following apply.
Account owner qualifies and takes advantage of the saver's credit
Account has minimum balance of $2,000
Minimum monthly systematic investment of $150 is established
Account owner purchases a Refund Anticipation Loan

** An account is exempt from the account maintenance fee if there is a minimum systematic investment of $25 per month established, or if the account balance is at least $1,000.

The state of New York argues there is fraud unless there is a full disclosure that the cost of preparing a person's tax return increases if he or she makes an IRA contribution or takes an IRA distribution.

The state of New York also argues that the use of a very small font is automatically fraud because, in effect, there has been no disclosure. H&R Block used very small print to set forth the disclosure of what fees or other compensation they were being paid by the seller of the special money market account.

CWF Comment. H&R Block is highly susceptible to the claim that their fee schedules were deceptive. These fees disclosures were prepared poorly. In a lawsuit, the plaintiff only needs to prove one of its claims. The plaintiff is not required to prove all of its claims.

If it is true that H&R Block did not furnish the Disclosure Statement (and a complete fee chart) to its customer until 2-3 weeks after signing the IRA application page, then H&R Block will lose. Not furnishing these required items timely is deceptive.

There are other reasons to reach the conclusion there has been deception by H&R Block.

The disclosure gives the impression that the $15 fee to open the account will not normally be charged. The details are in the "footnote." The fact is, the account opening fee is assessed often.

The disclosure gives the impression that the $15 fee to contribute additional funds to the account will not normally be charged. This fee, too, is assessed often.

Although we are not sure it is required, it would have been best if H&R Block would have explained to the taxpayers that their tax preparation fees will be higher if they make an IRA contribution than if they don't.

Summary. All financial institutions should be watching this lawsuit. It is not every day that the largest tax preparation company in the country is sued for fraud and deception regarding various IRA products and services offered in relationship to its tax preparation business.

The state of New York is arguing that all marketing materials and other IRA disclosures must be very comprehensive and must be furnished on a timely basis.

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New York State law provides for a penalty of $500 for each improper disclosure. $500 times 500,000 IRAs results in a liability of $250 million.

Although we at CWF are not a fan of Attorney General Eliot Spitzer, it appears to us that H&R Block is going to have some difficulty proving that their fee disclosures were not deceptive. The Wall Street Journal has reported that the state of New York would have agreed to settle for $30 million dollars prior to commencing the lawsuit. H&R Block management adopted the public response that they have done nothing wrong and that Mr. Spitzer is grandstanding for political purposes. Settling for $30 million may no longer be an option. Unless H&R Block can prove that they furnished better disclosures than the court file shows at this point, we at CWF believe H&R Block is at risk that a judge or jury would find their fee disclosures deceptive. From the shareholders viewpoint, a settlement may have been prudent and may still be prudent. We will keep you informed as to what happens with this case. ◆

Will the IRS Show Up at the Door of H&R Block, Inc.?

There is a good chance the IRS will show up at H&R Block's door. The IRS reads newspapers and watches TV also.

The state of New York has already conducted a certain amount of discovery with respect to its suit against H&R Block. The documents set forth along with the Complaint show that H&R Block has some serious IRA compliance problems. The fact that a company is big does not mean they do things the way they are supposed to be done.

First, H&R Block has written into its IRA plan agreement and other disclosures that the $15 opening fee is non-returnable, even if the individual exercises his or her right to revoke the establishment of his or her IRA. We at CWF are aware of no authority which allows the IRA custodian to ignore the rule set forth in the IRA regulation that the IRA custodian must return the full amount of the initial contribution if the IRA is revoked.

Second, it appears that H&R Block may not be complying with the IRA rule, again set forth in the regulation, that they must furnish a copy of the IRA plan agreement and disclosure statement to the customer. Although the regulation does not expressly require furnishing these documents immediately, it is certainly implied. In addition, the regulation does not authorize the furnishing of these documents 2-3 weeks after the signing of the IRA application. The IRS may assess a $50.00 penalty for each failure to furnish a plan agreement and $50.00 for each failure to furnish a complying disclosure statement.

Third, the IRA plan document of H&R Block states that if the IRA is rescinded, there will be no governmental reporting of the contribution or the distribution. Whether its a recision or a revocation, we are unaware of any authority for H&R Block or any financial institution serving as an IRA custodian, to not report certain transactions to the IRS. All IRA transactions (except certain transfers) must be reported to the IRS and the IRA accountholder. The IRS has the authority to assess, in general, a penalty of $50.00 for each transaction required to be reported, but which was not.

In summary, we would not be surprised if the IRS decides to audit H&R Block, which appears to have a number of serious compliance deficiencies. ◆

Nonspouse Beneficiary Paying Final Expenses from a Decedent's HSA

If an HSA account owner names a nonspouse beneficiary to their HSA, how is a distribution to this beneficiary handled, if the funds are used to pay the decedent's final medical expenses?

Code section 223(f)(8)(B)(i) provides the rule that, with respect to a nonspouse beneficiary, the HSA ceases to be an HSA as of the date of death of the account owner, and the fair market value of the HSA must be included in the beneficiary's gross income for such year of death. This is the rule, regardless of whether or not there are medical expenses which need to be paid with respect to the deceased account owner.

The HSA custodian will prepare the Form 1099-SA to show the "gross distribution" and the fair market value as of the date of death. These amounts may not be the same. The gross distribution amount may be larger than the fair market value, if the HSA funds were invested in the stock market, due to market fluctuations.

If medical expenses are paid from the HSA funds, this will complicate the beneficiary's tax reporting, because the same amounts could be reported twice on a Form 1099-SA. The beneficiary would have to furnish an explanation for the amounts shown on all Forms 1099-SA received.

The amount of the HSA funds which are taxable to the beneficiary is allowed to be reduced by any qualified medical expenses paid for the decedent from the HSA account, within one year of the account owner's date of death. The beneficiary will need to complete Form 8889. The gross distribution amount will be entered on line 12a of the form, and the medical expenses will be entered on line 13. The net taxable amount will be entered on line 14. If the medical expenses exceed the amount of the HSA, the taxable amount of the HSA distribution to the beneficiary will be zero (0).

The instructions for Form 8889 state: "If the designated beneficiary is not the account beneficiary's surviving spouse, or there is no designated beneficiary, the account ceases to be an HSA as of the date of death. The beneficiary completes Form 8889 as follows.

- Enter "Death of HSA account owner" across the top of Form 8889.
- Enter the name(s) shown on your tax return and your SSN in the spaces provided at the top of the form, and skip Part I.
- On line 12a, enter the fair market value of the HSA as of the date of death.
- On line 13, for a beneficiary other than the estate, enter qualified medical expenses incurred by the account owner before the date of death, that you paid within 1 year after the date of death.
- Complete the rest of Part II. ◆

IRS Form 5498 Reporting Compliance

Fair Market Value (FMV) statements were due to all IRA accountholders and beneficiaries with a balance as of December 31, 2005. They were also due for the IRA accountholders who died during 2005. In addition, by May 31, 2006, a complying IRS Form 5498 must be sent to these accountholders and to the IRS. There are a number of ways to comply with this requirement.

Option 1 – The IRA custodian/trustee could have furnished a complying FMV statement to all required recipients by January 31, 2006. Then, by May 31, 2006, a Form 5498 could be mailed to all required recipients. There is much duplication in this process, but none the less complying.

Option 2 – Once again, the IRA custodian/trustee could have furnished a complying FMV statement to all required recipients by January 31, 2006. Then, by May 31, 2006, Form 5498 is sent to only those IRA accountholders who made reportable contributions for 2005. This would include all traditional and Roth IRA contributions made for 2005, and all rollovers, recharacterizations, SEP and SIMPLE contributions made in 2005. While there is still some duplication in this procedure, it is not as burdensome as Option 1.

Option 3 – Here, a Form 5498 or complying substitute was furnished by January 31, 2006. This would include all contributions as well as the FMV. A cor-

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IRS Form 5498 Reporting Compliance, Continued from page 6

rected 5498 then only needs to be sent to those accountholders who made traditional or Roth IRA contributions for 2005 between January 1 and April 17, 2006. Based on conversations CWF has had with the IRS, the second or corrected 5498 or substitute must be noted as "corrected" to the accountholders. They would, however be reported as "originals" to the IRS, whether sent via paper, magnetic media or electronically.

Reminder— Upcoming Reporting Deadlines

March 31, 2006 – This is the last day to file 2005 reports to the IRS if you do so electronically via modem or the internet.

May 1, 2006 – Fair Market Value statements for Coverdell ESAs are due by this date if the FMV has not already been reported to the designated beneficiary.

May 31, 2006 – This is the due date for Forms 5498, 5498-ESA, 5498-SA to be provided to the accountholders and the IRS. ◆

Contribution Deadline

The final due date for making contributions for most taxpayers, for 2005 is April 17, 2006, the due date for filing their federal income tax return, excluding extensions. Since the normal April 15 date is a Saturday, the date is extended to the next Monday, April 17. This includes all traditional and Roth IRA, Coverdell Education Savings Account and Health Savings Account contributions.

The IRS has indicated that contributions properly postmarked by that date can be accepted by the custodian/trustee if they choose to do so, but they are not required to. If the contributions are accepted for 2005, they must be reported on the 2005 5498s. If your procedures are to only accept those contributions that are received in your office by the close of business April 17, that is also acceptable.

NOTE: There is one exception for the April 17 date. IRS Notice 2006-23 reminds certain taxpayers in six eastern states and the District of Columbia that they have until April 18, due to Patriot's Day. Taxpayers served by the Andover, MA, IRS processing center get the extra day due to the state-observed holiday. This deadline applies to all taxpayers in Maine, Maryland, Massachusetts, New Hampshire, New York, Vermont and the District of Columbia. Even though some taxpayers in these states send their returns and payments outside Massachusetts, to avoid confusion, the IRS has indicated that all taxpayers in these states get the extra day—to April 18. ◆

Not Amending in a Timely Fashion Can Be Costly

Some financial institutions (including many brokerage companies) tend to believe there are not time limits as to when they must amend their traditional IRAs, Roth IRAs or SIMPLE-IRAs.

The IRS has recently released a Special Edition of their newsletter, *Retirement News for Employers,* which has been reprinted in the following article. The IRS makes clear that an employer who sponsors a SIMPLE-IRA plan had better have executed the 2002 version of the Form 5305-SIMPLE or Form 5304-SIMPLE. This should have been done on or before December 31, 2002.

If an employer failed to adopt such an updated plan, then the IRS has decided to grant special relief to the employer as long as the employer signs an EGTRRA complying SIMPLE-IRA document on or before December 31, 2006. Without such special relief, these employers and their employees would have a tax mess. An employer would not be entitled to claim deductions for their contributions, and excess contributions would exist with the SIMPLE-IRAs.

Any financial institution which has customers or clients in an IRA form written before 2002 is subject to being fined by the IRS—$50 for each old plan agreement and $50 for each old disclosure statement.

If you need help with such amendments, you may call the customer service department of CWF at 1-800-346-3961. ◆

IRS Article from "Retirement News for Employers"

IRS OFFERS RELIEF TO EMPLOYERS WITH SIMPLE-IRA PLANS

Helping Business Owners with Retirement Plans Special Edition, March 10, 2006

Employer Plans (EP) established an examination project on SIMPLE-IRA plans in January 2005. During the initial phase of the project, EP examiners discovered that many employers had failed to update their plans for the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Some employers questioned whether there was a need to amend their SIMPLE-IRA plans for EGTRRA. The answer is a resounding "Yes."

Examiners were instructed, based on early findings, to check the date on the employers' plan documents. They were seeing a significant number of SIMPLE-IRA plans that had not been updated for EGTRRA. Plans not in compliance with this requirement could lose all the retirement savings and tax benefits that these plans provide to both the employers sponsoring them and the employees participating in them.

Based on these findings EP is offering employers with SIMPLE-IRA plans an extended time to update their plans for the provisions of EGTRRA. Employers that previously failed to amend their SIMPLE-IRA plans for EGTRRA have until **December 31, 2006,** to either adopt the latest version of the IRS model SIMPLE-IRA plan (revised August 2005) or adopt another SIMPLE-IRA plan document that has been updated for EGTRRA.

Through a review of 2004 Form W-2 information, EP identified approximately 190,000 employers with SIMPLE-IRA plans. EP is planning on sending these employers a letter informing them of this limited relief opportunity so they can update their SIMPLE-IRA plans for EGTRRA if they have not already done so.

EP has information on the **Retirement Plans Community web page** on this initiative with links to:

- SIMPLE-IRA Plan Relief for Employers (**Letter 4083**);
- SIMPLE-IRA Plan Relief—Pension/IRA Department (**Letter 4084**);
- Relief for SIMPLE-IRA Plans **FAQs**;
- **EGTRRA Background Paper**; and
- **Form 5305-SIMPLE** and **Form 5304-SIMPLE**.

The mail-out effort will start in early March, with an initial test mailing of 1,000 letters. Subsequent mailings will start in early April, with a plan to mail out between 10,000 and 15,000 letters a week until all 190,000 have been mailed out. ◆

FDIC Press Release

FDIC INSURANCE FOR RETIREMENT ACCOUNTS INCREASED TO $250,000

Higher coverage takes effect April 1; Basic insurance limit for other accounts stays at $100,000

The Federal Deposit Insurance Corporation (FDIC) Board of Directors today approved final rules that will raise the deposit insurance coverage on certain retirement accounts at a bank or savings institution to $250,000 from $100,000. The increase, the result of a new law boosting federal deposit insurance coverage for the first time in more than 25 years, will become effective on April 1. The basic insurance coverage for other deposit accounts, however, will remain at $100,000.

"The increase in deposit insurance coverage on certain retirement accounts is a significant change," said Martin J. Gruenberg, Acting Chairman of the FDIC. "The FDIC is committed to helping depositors understand clearly the change that has been made and how it will affect the deposit insurance coverage for which they are eligible."

Under the FDIC's new rules, up to $250,000 in deposit insurance will be provided for the money a consumer has in a variety of retirement accounts, primarily traditional and Roth IRAs (Individual Retirement Accounts), at one insured institution. Also included are self-directed Keogh accounts, "457 Plan" accounts for state government employees, and employer-sponsored "defined contribution plan" accounts that are self-directed, which are primarily 401(k) accounts. In general, self-directed means the consumer chooses how and where the money is deposited.

In addition, the IRAs and other retirement accounts that will be protected under the new rules to $250,000 are insured separately from other accounts at the same institution that will continue to be insured up to at least $100,000. To learn more about FDIC deposit insurance, see the resources listed later.

The new law also established a method by which the FDIC would consider an increase in the insurance limits on all deposit accounts (including retirement accounts) in the future, but only every five years starting in 2011. Any such increase would be based, in part, on inflation. Otherwise, accounts will continue to be insured as described above. ◆

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Use the Proper Forms for Recharacterizations

With tax season upon us, many individuals will be told by their accountants that, because of income limits, they are not eligible to deduct their traditional IRA contributions made for 2005. That is, they made too much money, and are not allowed to make a deductible contribution to their IRA. The easiest solution to this problem is to recharacterize the contribution to be a Roth IRA contribution instead.

A recharacterization can only be made for 2005, if it is accomplished by the tax-filing deadline of the individual plus six months. The normal tax-filing deadline for most individuals is April 15. Generally, then, an individual has until October 15, 2006, to recharacterize an IRA contribution made for 2005.

It is important to document this recharacterization, so that the custodians of both IRAs are aware of the transaction. CWF has created special forms for this situation.

One form, CWF's Form #54-TR "Notice of Recharacterization of IRA Contribution," is recommended. It collects the following information:

1. Type and amount of the contribution to the first IRA that is to be recharacterized.

2. The date on which the initial contribution was made.

3. A direction to the custodian/trustee of the first IRA to transfer the amount of the contribution, plus the allocable net income, in a trustee-to-trustee transfer to the custodian/trustee of the second IRA.

4. The name of the first and second custodian/trustee.

5. Acknowledgement by the accountholder, and the current and successor custodian, that they understand the situation, and that the recharacterization will be handled and reported correctly.

An institution will also want the accountholder to understand the tax issues associated with a recharacterization, and how the individual must handle it on their tax return. CWF Form #56-TREX for 2005 provides this information.

The income earned on the amount recharacterized must also be transferred with no tax penalty. This is a valuable tax advantage. CWF has created a form to use to calculate the applicable interest on the contribution — Form #67-W.

The three forms mentioned here are reproduced on page 10.

Of course, the applicable plan agreement must also be completed, if the individual does not already have the correct type of IRA established.

Summary. Recharacterizations are becoming more popular. A financial institution will want to be certain to document these transactions correctly. The forms used must collect the needed information concerning the funds in question, the accountholder, the current IRA custodian/trustee and the successor custodian/trustee. CWF has these special forms available. ◆

What Is an Inherited IRA?

Once an IRA accountholder dies, his or her IRA becomes an inherited IRA. This happens as a matter of law. The IRA funds will now be used to benefit the beneficiary(ies) rather than the IRA accountholder. There are required distribution rules which apply to the beneficiary(ies) once the IRA accountholder dies. Each and every distribution to a beneficiary from an inherited IRA must be coded a "4" for death, for Form 1099-R reporting purposes.

A final Form 5498 must be prepared using the IRA accountholder's name and social security number. The IRS has given the IRA custodian two options. It may either report the fair market value as of the time of death, or it may report a "0" and instruct the executor that he or she may request the value as of the date of death.

A Form 5498 must be prepared for each inheriting beneficiary showing the fair market value of his or her share as of December 31. If the value is "0" because the beneficiary withdrew his or her entire share, then a Form 5498 does not need to be prepared.

IRA software generally handles the subject of an inherited IRA in one of two ways. Under the first approach, the "system" is instructed that the IRA accountholder has died. Various sub-accounts are

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CWF's Recharacterization Forms

These forms are discussed in the article, "Use the Proper Forms for Recharacterizations," page 9.

CWF'S Form 54-TR

Notice of Recharacterization of IRA Contribution

To: Current Custodian/Trustee

Name:
Address:
City/State/Zip:
Phone: ( )

Date:

From: Depositor or Grantor

Name:
Address:
City/State/Zip:

SSN:
Date of Birth:
Phone: – House:
Work:

I hereby instruct you that I wish to irrevocably recharacterize my previous contribution. The successor IRA will be with the ☐ current custodian/trustee or ☐ a successor custodian/trustee as indicated below. If I have indicated a successor custodian/trustee, then you are to issue a check for the amount indicated below to the successor custodian or trustee. I understand I must provide the following information to have my previous contribution recharacterized:

The Original Contribution
Account Number:
Date of Contribution:
Amount:

The Recharacterized Contribution
Account Number:
Date of Contribution:
Amount:

Type of Original Contribution (Check only one)
☐ 1. Conversion/Rollover to Roth IRA → **Type of Recharacterized Contribution** 1. Rollover to a traditional IRA
☐ 2. Annual Contribution to a Roth IRA for _____ tax year → 2. Annual contribution to a traditional IRA for the same tax year
☐ 3. Annual contribution to a traditional IRA for _____ tax year → 3. Annual Contribution to a Roth IRA for the same tax year

Instruction and Amount to Recharacterize

I elect to recharacterize $
Which is ☐ all or ☐ a portion of my original contribution.
It is adjusted by:
a. Related Earnings (loss or)
b. Interest Penalty fee
c. Administrative Fee
d. Other
e. Recharacterized Net Amount

I instruct you to transfer the recharacterized net amount to the successor custodian/trustee. I want this recharacterized net amount to come from the following assets held within my referenced IRA and paid in the instructed manner. I understand that there may be various fees associated with liquidating and/or transferring such assets in kind. These fees are set forth above. I authorize you to deduct such fees from the IRA.

☐ Liquidate all or my accounts and transfer the cash proceeds by sending a check to the successor custodian/trustee;

☐ Liquidate the accounts I specify below and transfer the cash proceeds by sending a check to the successor custodian/trustee;

☐ Transfer all such assets "in kind" to the successor custodian/trustee;

☐ Transfer "in kind" the assets I specify below to the successor custodian/trustee;

I acknowledge that you have instructed me to consult with my legal or tax advisor because of the complexity and importance of this matter. This recharacterization is being made on or before the due date (including extensions for filing my individual Federal income tax return for the taxable year for which the contribution was made). I expressly assume all responsibility for this recharacterization of IRA funds. I realize that my election to recharacterize my contribution is irrevocable.

Signature of Depositor or Grantor: **Date:**

Acknowledgment of Current IRA Custodian/Trustee:

We acknowledge receiving your recharacterization instruction. We will report the original contribution on Form 5498, showing the character of the contribution (annual, conversion, etc.) and will report the distribution or recharacterization on Form 1099-R per the current IRS instructions. If your recharacterized contribution has been made into an IRA that you maintain with us, then we will also report the aforementioned contribution as a recharacterized contribution on a Form 5498 (Box 4).

Signature of Current Custodian/Trustee: **Date:**

Acceptance by Successor IRA Custodian/Trustee:

We, the successor custodian/trustee, agree to report the recharacterized contribution as identified above as a recharacterized contribution on Form 5498 and agree to accept this contribution as if it had originally been made to us rather than the previous trustee/custodian.

Successor Custodian/Trustee: Phone:
Address:
City/State/Zip:

Signature of Successor Custodian/Trustee: **Date:**

SA 54-TR (2/06) White – Original Custodian Trustee Yellow – Successor Custodian Trustee Pink – Depositor Copy © 2006 Collin W. Fritz & Associates, Ltd.

CWF'S Form 56-TREX (2005)

Special Explanation to Accountholder for an IRA Recharacterization for the 2005 Tax Year

_____
(Name of Accountholder)

The purpose of this special explanation is to provide you with information about your recharacterization. You recharacterized a contribution which you made for the 2005 tax year. You will need to properly report and explain your recharacterization when you file your 2005 federal income tax return. We have furnished to you a copy of the *IRA Recharacterization Form* which you executed. You will also want to review the 2005 instructions for Form 8606. The IRS' instructions require you, as the IRA accountholder, to attach an explanation to your income tax return indicating the original contribution amount, the amount which was recharacterized, and the amount of earnings which was recharacterized. You may attach a copy of the IRA Recharacterization Form for this purpose.

In some situations you will need to do more than just attach an explanatory statement. If both the original contribution and the recharacterization occurred during 2005, then you must also include on the 2005 tax return the amount deemed distributed from the one IRA on Form 1040, line 15(a) (or similar form). This is the gross amount you recharacterized. You should also complete line 15(b), the taxable amount, with zero. If the recharacterization of the contribution for 2005 occurred in 2006 then you only need to attach the explanatory statement.

Accountholder _____ Date _____

_____ Date _____

CWF'S Form 67-W

Worksheet to Calculate the Income Related to the Withdrawal of a Current-Year Contribution(s)

Custodian/Trustee Information
Name
Address
City State Zip
Attn: Phone

Accountholder
Name
Home Address
City State Zip
County Date of Birth
SSN Plan No.

IRA Account Information
Account Number
Type: ○ Traditional ○ Roth

Purpose: This form is used to calculate the interest or other income earned with respect to a current-year contribution which is being withdrawn under Internal Revenue Code section 408(d)(4). The formula set forth in IRC Regulation 1.408-4(c)(1) is being used.

Date of Contribution(s)
Amount of Contribution(s)
Date of Distribution

1. Amount of Current-Year Contribution(s) to be Withdrawn. 1.
2. Adjusted Closing Balance:
   a. FMV (immediately prior to withdrawal) (FMV = Principal + Interest + Accrued Interest) 2(a).
   b. Distributions during computation period 2(b).
   c. Total Adjusted Closing Balance (line 2a + 2b) 2(c).
3. Adjusted Opening Balance:
   a. FMV (immediately prior to contribution) (FMV = Principal + Interest + Accrued Interest) 3(a).
   b. Contributions during computation period 3(b).
   c. Total Adjusted Opening Balance (line 3a + 3b) 3(c).
4. Subtract line 3c from line 2c (this may be a negative number) 4.
5. Divide line 4 by line 3c (a quotient to 4 decimal places) 5.
6. Income (loss) Related to the Current-Year Contribution Being Withdrawn (multiply line 5 by line 1) 6.
7. Total amount to be withdrawn (line 1 + 6) 7.

Signature of Custodian/Trustee Date Signature of Accountholder Date

Additional Discussion – See Reverse Side

IRA #67-W (Current Year) (2/06) © 2006 Collin W. Fritz & Associates, Ltd.

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**What Is an Inherited IRA?
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automatically set up for the inheriting beneficiary or beneficiaries and the proper amount of money is transferred into each such subaccount. Under the second approach, the software is not written as comprehensively. In order to generate governmental reports to each beneficiary, a separate account needs to be set up for each beneficiary on the computer system independent of the account for the original IRA accountholder. The funds are then transferred from the deceased IRA accountholder's account to the "inherited IRA" of the beneficiary. Such transfers are nonreportable for Form 1099-R and Form 5498 reporting purposes. The account title, "John Doe as beneficiary of Jane Doe's IRA" should be used so that both the inheriting beneficiary and the IRS understand that the account being reported is an inherited IRA account.

Because so many mainframe computer systems use the second approach, CWF has written its contribution and distribution forms to show that funds are transferred from the decedent's IRA and transferred into the inherited IRA. ◆

Valuation of IRA Annuity Roth Conversions

Recently the IRS issued temporary and proposed regulations addressing IRA annuity valuations when they are converted to Roth IRAs. With no previous specific rule for this valuation, the IRS apparently felt the traditional and SIMPLE-IRA annuities were being artificially undervalued prior to the conversion.

Some annuity contracts have been designed and promoted to limit the amount of income that is recognized upon conversion to a Roth IRA. In these instances, the IRS and the Treasury Department have concluded the cash surrender value is unrealistically low, only to be remarkably increased a short time after the conversion.

To alleviate this situation, the IRS has issued a temporary amendment to Treasury Regulation Section 1.408A-4 stating very clearly how the fair market value of the IRA annuity is to be calculated when converting to a Roth IRA.

The preamble to the temporary regulation states that the amount of the IRA annuity being converted is treated as distributed at the fair market value of the annuity contract as of the date of the conversion, and that this amount is not always the same as the cash surrender value. The following provisions are provided in the temporary and proposed regulation.

1. If the conversion occurs soon after the annuity was purchased, the fair market value of the IRA annuity is established by the premiums paid.

2. If the conversion occurs after the annuity contract has been in force for some time, and no other premium payments are to be made, the fair market value is determined by the annuity company through the sale of comparable contracts.

3. If the conversion occurs after the annuity contract has been in force for some time, and other premium payments are to be made, the fair market value is determined by using "an approximation that is based on the interpolated reserve at the date of the conversion, plus the proportionate part of the gross premium last paid before the date of the conversion which covers the period extending beyond that date." If this approximation is not reasonably close to full value, this method cannot be used.

Additional IRS guidance will include formulas for calculating the fair market value and whether or not the same valuation will be used for the purposes of taxation and penalties under Internal Revenue Code (IRC) section 408(e) and the calculation of required minimum distributions under IRC 401(a)(9). ◆

Early Withdrawal Fees

Financial institutions, as you are aware, are permitted to assess early withdrawal fees on certain deposits such as time deposits. These fees must be disclosed in compliance with the truth-in-savings regulations. Financial institutions need to have a set policy concerning early withdrawal fees. This policy needs to clearly define situations when an early withdrawal fee will be waived and when it will not be waived.

Because interest rates seem to be taking an upward trend, financial institutions will more and more be encountering IRA customers who bought a time deposit at a lower interest rate and will now want to

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Early Withdrawal Fees
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invest the funds at a higher interest rate; these customers will want the institution to waive any early withdrawal penalties. Banking rules allow a financial institution to waive the fee if the account is an IRA, and the IRA accountholder is age 59 ½ or older. It has been brought to CWF's attention that, in many cases, IRA accountholders assume they will be able to withdraw funds from a time deposit early, without penalty, if the reason is to purchase another IRA time deposit at a higher interest rate. We have heard of some institutions allowing such a transaction once per year.

Although the waiving of an early withdrawal penalty is solely at the bank's discretion, an institution will want to have a written policy which clearly explains situations when the early withdrawal penalty will be waived.

Once an institution has its policy firmly in place, it must be certain to communicate this policy to its IRA customers, so that there will be no misunderstanding concerning early withdrawal fees and the conditions under which such fees will be waived. ◆

Suggestion for When You Calculate the Income Related to an Excess Contribution

The IRS has issued a formula to calculate the income related to an excess contribution. Under this formula, the income is determined from the moment of contribution through the moment just before the excess contribution is withdrawn. This requires the IRA custodian to know the fair market value of the account at the moment of the contribution and also the fair market value of the account at the moment before the excess contribution is withdrawn. **In order to determine the fair market value of the account at these two moments in time, the IRA custodian must remember that the account's accrued interest or other accrued earnings must be determined and included in the fair market value at these two moments in time.** ◆

Dramatic Growth of Health Savings Accounts (HSAs) from U.S. Treasury

Fact Sheet

Then (2004)...

• **438,000**—Individuals were covered in November 2004 by HSA-type insurance plans—according to the America Health Insurance Providers (AHIP).

• **113,000 (roughly 240,000 individuals)**—IRS data on individual tax returns reporting HSA deductions in tax year 2004.[1]

Now...

• **3.2 million**—Seven fold increase to individuals covered by HSA-type insurance plans (November 2004 to December 2005)—according to AHIP.

- **31%**—Previously uninsured individuals buying health insurance on their own.
- **33%**—Small businesses not previously offering coverage.
- **Nearly 50%**—Age 40 or over.

• **$1 billion**—Dollars invested in HSAs by Americans, according to data gathered by Inside Consumer-Directed Care (ICDC) newsletter February 24 issue—based on financial data provided by more than 60 financial firms including JPMorgan, Chase, Wells Fargo and The Principal Financial Group.

• **42%**—Number of individuals of families with incomes below $50,000 buying HSA-type insurance on their own, according to "Health Savings Accounts: The First Six Months of 2005" report by eHealthInsurance.

The Future...

• **14 million by 2010**—Treasury Department projection of HSA policies (covering 25 to 30 million people)—based on current law.

• **21 million by 2010**—Treasury Department HSA policies estimates rise by 50 percent (covering 40 to 45 million people)—based on the President's heath care initiative. ◆