THE Pension Digest

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ALSO IN THIS ISSUE –

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

Saver's Credit Will Expire with the 2006 IRA Tax Year

There is currently discussion in Congress to extend the expiration date of the Saver's Credit, or to possibly make it a permanent tax credit. This credit was authorized under EGTRRA for years 2002-2006. The purpose was to encourage low- and moderate-income individuals to make IRA contributions. If no action is taken by Congress, the Saver's Credit will expire with the 2006 IRA tax year.

Because a tax credit reduces an individual's tax liability dollar-for-dollar, this credit is quite valuable for those who qualify to use it. In order to receive the credit, an individual or couple must be within certain income limits; the maximum credit is $1,000.

Financial institutions should be certain they are informing their customers about this credit — possibly resulting in increased IRA deposits for the institution. CWF believes that if customers understood this tax credit, they would be more likely to make an IRA contribution. ◆

Consequence of Not Explaining a Recharacterization to the IRS

Individuals who recharacterize a contribution are required to explain the recharacterization to the IRS on their tax return. Failure to do so will most likely result in the individual receiving a letter from the IRS stating that additional tax is owing.

Example: Bob made a $3,000 Roth IRA contribution in March of 2005, for 2004. After meeting with his accountant, Bob discovered that he was not eligible to make a Roth IRA contribution, and, instead, came into the bank to recharacterize the contribution to be a traditional IRA. He correctly recharacterized the $3,000, plus the related interest of $10, on April 10, 2005. On April 12, 2005, Bob made another $500 to this same traditional IRA, for 2004. On his tax return, he claimed a deduction of $3,500; he did not attach an explanation of the recharacterization.

In April of 2006, the IRS sent Bob a letter stating that the bank only shows a $500 contribution to a traditional IRA for 2004, not $3,500, and, therefore, Bob owes additional taxes. The solution is simple; Bob simply needs to reply to the letter by explaining the recharacterization (which means the claimed deduction was correct), and apologizing for not sending an explanation with his tax return. However, Bob will most likely come to the bank for help with this situation, as most individuals may be

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RMDs as a Percent — Revised RMD Uniform Lifetime Table

We have prepared a new "Percentage" RMD table. It shows the required minimum distribution as a percentage. For example, a person age 72 in 2006, is required to withdraw, for 2006, 3.9% of his or her 12/31/05 account balance as their 2006 RMD.

In the following chart, we have converted the denominator in the RMD calculation formula to a percentage. The 12/31 balance in an IRA account may be multiplied by this percentage to achieve the same result as dividing by the "distribution period."

The IRS was very generous when they proposed revised rules in 2001, and finalized these new rules in 2003. Every person receives the benefit of using a "joint life expectancy," and that is why only 7.46% is required to be withdrawn by a person age 87.

Observation: By listing this percentage, an accountholder can readily see the affect a distribution will have on their account. For an accountholder taking the minimum distribution from their account, if their investments are earning a percentage greater than the listed percentage, they will see their account balance grow, even though they have taken a distribution. If their investments are earning a percentage which is less than the listed percentage, they will see their account balance decrease, but only by the difference in the percentages, which may be a small percentage.

Example #1: If an individual, age 72, has a 12/31/05 account balance of $10,000, his RMD for 2006 will be $390.63 ($10,000/25.6, or $10,000 x .039063). If this individual's investments are earning 6%, even if interest is only compounded annually, the individual will earn $600. Therefore, having to take a required distribution amounting to only 3.9% of the account, while earning 6%, actually results in an increase in the account balance.

Example #2: If, on the other hand, an individual, age 87, has a $10,000 balance as of 12/31/05, his 2006 RMD would be $746.27 ($10,000/13.4, or $10,000 x .074627). If this individual's investments are earning 6%, compounded annually, the individual will still earn $600. However, obviously, the account will decrease. But the decrease is very minimal — only $146.27, or 1.46% — the difference between the RMD percentage and the earnings percentage (7.46 - 6).

See page 8 for a revised Single Life Table reflecting the required distribution as a percentage.

Uniform Lifetime Table— The Percent Method

Age	Distribution Period	%	Age	Distribution Period	%
70	27.40	3.65	93	9.60	10.42
71	26.50	3.77	94	9.10	10.99
72	25.60	3.91	95	8.60	11.63
73	24.70	4.05	96	8.10	12.35
74	23.80	4.20	97	7.60	13.16
75	22.90	4.37	98	7.10	14.08
76	22.00	4.55	99	6.70	14.93
77	21.20	4.72	100	6.30	15.87
78	20.30	4.93	101	5.90	16.95
79	19.50	5.13	102	5.50	18.18
80	18.70	5.35	103	5.20	19.23
81	17.90	5.59	104	4.90	20.41
82	17.10	5.85	105	4.50	22.22
83	16.30	6.13	106	4.20	23.81
84	15.50	6.45	107	3.90	25.64
85	14.80	6.76	108	3.70	27.03
86	14.10	7.09	109	3.40	29.41
87	13.40	7.46	110	3.10	32.26
88	12.70	7.87	111	2.90	34.48
89	12.00	8.33	112	2.60	38.46
90	11.40	8.77	113	2.40	41.67
91	10.80	9.26	114	2.10	47.62
92	10.20	9.80	115 +	1.90	52.63

The Uniform Lifetime Table is used to calculate the RMD for unmarried owners; married owners whose spouses are not more than 10 years younger; and married owners whose spouses are not the sole beneficiaries of their IRAs. ◆

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SEPs — The Last-Minute Retirement Plan

Definitions

SEP — SEP is the acronym for Simplified Employee Pension plan. In order to have a SEP, two requirements must be met. First, an employer must sign a SEP plan document which may be: (1) the IRS model Form 5305-SEP; (2) a SEP prototype; or (3) a SEP plan as written specifically for that employer by an attorney. The employer may be a gigantic corporation or a self-employed person. Second, all eligible employees must establish (or have established for them) a SEP-IRA.

SEP-IRA — A SEP-IRA is a standard, traditional IRA established with a financial institution which is willing to accept SEP contributions. The IRA custodian is required to report SEP-IRA contributions in box 8 on Form 5498. In all other respects, the standard, traditional IRA rules will apply to administering SEP-IRAs. Contributions to SEP-IRAs are always owned by the employee, once the funds have been contributed to the employee's SEP-IRA.

Discussion

SEP plans may be established and funded by the normal tax deadline, plus extensions. A person may come into your institution in July of 2006, and make a SEP contribution of $42,000, for tax year 2005. If an individual has the proper extension(s) a SEP contribution may be made as late as October 15 of 2006, for tax year 2005. Extensions are normally filed for four months, to August 15, with another filing available for an additional two months, to October 15.

The Contribution Rules Applying to SEPs are Very Favorable

1. The maximum contribution for 2005 is the lesser of $42,000, or 25% of a person's compensation. The limit for 2006 is $44,000.

2. The age 70½ eligibility rule which applies to traditional IRAs does not apply to SEP-IRAs. A farmer who is age 74 and still farming and has net income, may still make contributions to their SEP-IRA. A corporation (and any other employer) is required to make a contribution for any employee age 70½ or older, as long as the employee has met the eligibility requirements. The age discrimination laws prohibit an employer from not making such contributions.

3. All contributions made to a SEP-IRA by an employer are employer contributions, and are reported in box 8 of Form 5498. However, an individual is permitted to make his or her annual traditional IRA contribution to the same IRA to which a SEP contribution is made. Annual contributions are reported in box 1 on Form 5498. Such annual contributions may or may not be deductible.

4. An employer is not required to make contributions each year. Contributions are discretionary as to amount.

5. The contributions which an employer makes for its employees are deductible by the business entity on its tax return. A corporation will claim the deduction on Form 1120. A partnership will claim the deduction on Form 1065, and partners will be informed of their respective shares on Schedule K-1. A sole proprietor may deduct SEP contributions on his or her Schedule C for Form 1040.

6. Contributions by the employer to a person's SEP-IRA are not taxed for income tax purposes, withholding purposes, social security income tax purposes, medicare tax purposes, or federal unemployment income tax purposes.

7. There are special contribution rules for self-employed individuals. A self-employed individual does "deduct" his or her contribution amount to a SEP-IRA on Form 1040. That is, the amount contributed to the SEP-IRA is not excluded from income, as occurs for corporate employers. Since the maximum contribution is the lesser of 25% of compensation, or $42,000 for 2005, one must calculate the "compensation" for a self-employed individual. Compensation for a self-employed person is his or her net earnings from self-employment, as decreased by (1) the amount contributed to their SEP-IRA, and (2) 50% of his or her self-employment tax (the IRS has a special chart and formula to be used for this calculation).

8. An employer is required to provide each employee with an annual statement indicating the amount contributed to the employee's SEP-IRA for the year. A

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self-employed person is not required to prepare a statement for himself.

Other IRA Rules Applying to SEPs

All of the standard distribution rules and other rules which apply to traditional IRAs also apply to SEP-IRAs. The required distribution rules apply.

Example: John Thomas, age 74 is a self-employed farmer who had compensation of $64,000 for 2005. His SEP-IRA balance as of 12/31/05 was $84,000. On April 13, 2006, he made the maximum allowable contribution to his SEP-IRA — $16,000 (25% of his 2005 compensation), and designated it for tax year 2005. Because Mr. Thomas is older than age 70½, he must take a 2006 RMD. The custodian of Mr. Thomas' IRA sent him his RMD notice in January of 2006.
Mr. Thomas' RMD will be calculated using the 12/31/05 balance of $84,000. The $16,000 contributed on 4/13/06, does not change the 2006 RMD amount, even though the contribution was designated for 2005. Because SEPs are reported on a calendar-year basis, the 12/31 balance of the prior year is always used to calculate the RMD for the current year.

Summary. Because SEPs and SEP-IRAs are easy to establish and administer, financial institutions should be actively seeking these accounts. These accounts could result in greatly increased deposits for your institution. For your information, CWF has a lobby brochure available for you to give to potential employers, which explains the benefits of SEP accounts in easy-to-understand language. ◆

Missed RMD — What to Do

This time of year, we get many questions concerning IRA accountholders who have failed to take their 2005 RMD by 12/31/05. What should the accountholder and IRA custodian do?

The result of not taking the 2005 RMD amount timely is that, technically, the 50% excise tax is owing on the amount which was was not timely distributed. However, the IRS does have the authority to waive the 50% tax.

Bank's Mistake

If the reason the RMD was not distributed is because of a bank error, such as not sending an RMD notice or some other reason, there are two approaches to handling the additional tax issue.

1. Complete Form 5329 showing that the 50% tax is owing, attach the 5329 to the individual's 2005, 1040 tax return along with a check for the applicable amount. Then write a letter asking that the penalty tax be refunded, because the bank made an error (enclose a letter from the bank detailing this error).

2. Complete Form 5329 showing that the 50% tax is owing, and attach it to the individual's 2005, 1040 tax return along with an explanation letter from the bank detailing its error, and a letter from the accountholder stating that payment is not enclosed because they believe the IRS will waive the penalty because of the bank error. Also state that the correct amount was distributed as soon as the error was discovered.

If the individual has already filed their 2005 tax return, they can file an amended 1040X.

We have enclosed a sample letter to the IRS for situation #2 above, where the bank neglected to send the accountholder the required RMD notice.

Sample letter to IRS:

In 2005, I missed taking the RMD amount of _______________ from my IRA by 12/31/05, because of a bank error (see the attached letter from my bank).

I have filed my 2005 tax return. Therefore I am now submitting an amended 1040X return to claim and pay tax on the RMD amount. I am also enclosing Form 5329, which is what my bank told me to do, to notify you of the missed RMD amount. I have not paid the 50% required excise tax, because I am now writing to explain the situation and request that this 50% tax be waived. I understand that the IRS has the authority to waive the excise tax upon receiving a reasonable explanation as to why the amount was not timely distributed.

I understand that the rule is that the institution holding the funds on January 1 of any year is the institution responsible to send the RMD notice. Therefore, it was my bank's responsibility to send me the 2005 RMD notice; they did not.

I believe this is a reasonable explanation as to why my 2005 RMD was not distributed timely, and I respectfully ask that you waive the 50% excise tax.

Thank you for your consideration.

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**Missed RMD — What to Do,
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Individual's Error or Special Situation

If the reason the RMD was not distributed is the individual's oversight, or because of a special situation (family emergency, sickness, etc.), in all likelihood, the IRS will consider the 50% tax to be owing. However, the individual may still provide a reasonable explanation for the missed RMD and ask the IRS to waive the penalty. The IRS may or may not do so. ◆

Marriage and Qualifying as a First-Time Home Buyer

A first-time home buyer is defined in IRC section 72(t)(8)(D)(i) as any individual if "such individual (and if married, such individual's spouse) had no present interest in a principal residence during the 2-year period ending on the date of acquisition of the principal residence to which this paragraph applies."

Note that the test period ends on the date of purchase, and it starts two years before such date. If a person marries after the date of purchase, he or she will not become disqualified to use the first-time home buyer exception, even if they marry a person who had owned a principal residence within the 2-year testing period.

Illustration: Jane Doe and Mark Roe purchase a home on April 10, 2006, for $140,000. Each becomes a 50% owner. Jane Doe withdraws $10,000 from her Roth IRA on April 8, 2006, to be used as part of her share of the required down payment. At the time of this purchase, Jane qualifies as a first-time home buyer, since she has never owned a home. Mark does not qualify as a first-time home buyer, since he and some college roommates had owned a home within the last two years. In August 2006, Jane and Mark are married.

Jane will be able to claim the first-time home buyer exception, since she did not have an ownership interest in a principal residence during the 2-year period ending on April 10, 2006. The fact that Mark owned a home during this period will not disqualify her, since they were not married during the testing period. ◆

Are Bank Service Charges Taxable By a State for Services Rendered to an IRA, HSA, or Qualified Pension Plan?

CWF wrote a letter of inquiry to the Iowa Department of Revenue asking if sales tax may be imposed on services performed by a financial institution with respect to demand deposit accounts, health savings accounts and IRAs. Excerpts from the response we received are in quotations throughout this article.

The response we received states that Iowa sales tax will be imposed on "service charges of all financial institutions." The Iowa Department of Revenue "has interpreted the words "service charges" to apply to services related to a checking account but not a savings account."

"Service charges which relate to a depositor's checking account are the only gross receipts subject to tax under this rule..."

"For purposes of this rule, the term 'checking account' is characterized with reference to its common meaning rather than any technical definition. An account is a 'checking account' if withdrawals may be made from the account by a written instrument....such as a check, a draft, or negotiable order of withdrawal (NOW). NOW and super NOW accounts are specifically included within the meaning of 'checking account.' Excluded from the meaning of that term are certificates of deposit."

"All charges relating to a 'checking account' are taxable, not only those charges relating to withdrawals form the account by check. For example, charges for withdrawals by 'bank card' from a checking account would be subject to tax.........Charges for withdrawals by bank card from a 'savings account' would not be subject to tax."

Because HSA accounts are usually set up as a CD, or a savings or checking account, it appears that Iowa State sales tax (usually 6.5%, but differing in some counties), would be assessed on withdrawals from an HSA checking account. Financial institutions and HSA account owners will need to be aware of this sales tax issue. As noted in the response, CDs and savings accounts are specifically exempted from the sales tax.

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Preliminary Tax Data — IRA/Pension Statistics for 2004

IRA and SEP/SIMPLE/Keogh Deductible Contributions

28.2 billion dollars were contributed to traditional IRAs, SEP-IRAs, SIMPLE-IRAs and Keogh plans for the 2004 tax year.

Taxpayers made contributions of $18 billion to SEP-IRA plans, SIMPLE-IRA plans, and Keogh plans for the 2004 tax year, compared to $16.9 billion for the 2003 tax year. The percentage of increase was 6.4%. In comparison, taxpayers made contributions of $10.2 billion to traditional IRAs for the 2004 tax year, compared to $10.17 billion for the 2003 tax year. The percentage of increase was a mere .7%.

The number of contributors to the SEP/SIMPLE/Keogh plans for 2004 was 1.17 million, compared to 1.19 million for 2003. There was a decrease of 1.9%.

The number of contributors to traditional IRAs for 2004 was 3.38 million, compared to 3.46 million for 2003. There was a decrease of 2.4%.

The average 2004 SEP/SIMPLE/Keogh contribution, per return, was $15,365.

The average 2004 IRA contribution, per return, was $3,018.

Chart A shows that there has been a substantial change (37%) in the total contribution amount (5 billion dollars) to SEPs/SIMPLEs/Keoghs over the last four years, and in the average contribution amount, but also that there has been a decrease in the number of contributors.

Chart B shows that although the size of the average traditional IRA contribution has been increasing because of the changes in the contributions limits, there has been little change in the number of contributors.

CHART A — SEP/SIMPLE/Keogh Chart

Year	Contribution Amount	Number of Contributors	Average Contribution
2001	$13.1 billion	1.29 million	$11,048
2002	$16.3 billion	1.19 million	$13,774
2003	$16.9 billion	1.19 million	$14,202
2004	$18.0 billion	1.17 million	$15,385

CHART B — Traditional IRA Chart

Year	Contribution Amount	Number of Contributors	Average Contribution
2001	$7.41 billion	3.45 million	$2,148
2001	$7.41 billion	3.45 million	$2,148
2003	$10.16 billion	3.46 million	$2,936
2004	$10.20 billion	3.38 million	$3,018

What was the adjusted gross income (AGI) of those who made SEP/SIMPLE/Keogh contributions?

	Under $15,000	$15,001 to $29,999	$30,000 to $49,999	$50,000 to $99,999	$100,000 to $199,999	$200,000 Or more	Total
Number of Returns	24,599	34,864	103,282	308,556	368,536	331,256	1,171,091
% of Total Returns	2.1%	3.0%	8.8%	26.3%	31.5%	28.3%	100%
Contribution Amt. (in thousands)	$96,421	$153,491	$662,110	$2,570,070	$5,413,289	$9 billion	$18 billion
% of Total Contr.	.1%	.9%	3.7%	14.3%	30.1%	50.0%	100%

CWF Observations

1. $18 billion is a lot of money. It is 80% more than the amount of IRA contributions.
2. 50% of contributions ($9 billion) come from individuals with AGI of $200,000 or more.
3. 80% of contributions (14.4 billion) come from individuals with AGI of $100,000 or more.
4. 94.4% of contributions (17.0 billion) come from individuals with AGI of more than $50,000.
5. The average contribution is $15,348.

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Preliminary Tax Data — IRA/Pension Statistic for 2004,
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What was the AGI of those who made traditional IRA contributions?

	Under $15,000	$15,001 to $29,999	$30,000 to $49,999	$50,000 to $99,999	$100,000 to $199,999	$200,000 Or more	Total
Number of Returns	199,136	586,781	857,773	1,122,613	488,922	124,193	3,379,417
% of Total Returns	5.89%	17.36%	25.38%	33.22%	14.47%	3.68%	100%
Contribution Amt. (in thousands)	$425,355	$1,403,807	$2,476,994	$3,508,754	$1,748,009	$676,269	$10,239,186
% of Total Contr.	4.15%	13.71%	24.19%	34.27%	17.07%	6.61%	100%

CWF Observations

1. It may be surprising, but almost 18% of contributions come from filers with AGI of less than $30,000.

2. The largest contributors are those with AGI between $50,000 and $100,000. They contributed 34% of all IRA contributions.

3. The next largest group of contributors are those with AGI between $30,000 and $50,000. They contributed 24% of all IRA contributions.

4. The average IRA contribution, per return, was $3,000.

The Retirement Savings Tax Credit

This credit has now been in existence for 3 years (2002 - 2004). In order to try to induce individuals with low to moderate incomes to make IRA or 401(k) contributions, a special tax credit was authorized for 2002 - 2006.

What was the AGI of those who claimed this credit?

	Under $15,000	$15,001 to $29,999	$30,000 to $49,999	$50,000 to $99,999	$100,000 to $199,999	$200,000 Or more	Total
Number of Returns	290,425	2,464,608	2,604,707	2,073	0	0	5,361,813
% of Total Returns	5.42%	45.97%	48.58%	.03%	0%	0%	100%
Contribution Amt. (in thousands)	$66,735	$525,951	$433,994	$209	$0	$0	$1,026,889
% of Total Contr.	6.5%	51.22%	42.26%	.02%	0%	0%	100%

CWF Observations

1. Low- to moderate-income taxpayers were able to claim a credit of more than $1 billion. One would expect that a taxpayer's use of this credit would mean that the tax liability of such taxpayer would be reduced to zero (0).

2. The average credit per tax return was $195.

3. Note that 5.36 million returns claimed this saver's credit. This is more than the number of returns which showed a traditional IRA contribution (3.34 million). Contributions to a traditional IRA, Roth IRA, 401(k) plan or other elective deferral plan qualify a person for this credit.

4. 42.3% of the credit is claimed by filers with AGI of between $30,000 and $50,000.

Summary. Congress is considering making the 2001 tax-law changes permanent. The increase in IRA contributions (from 7 billion per year to 10 billion per year) and the increase in SEP/SIMPLE/Keogh contributions (from 10 billion to 18 billion) are directly due to the 2001 law changes.

The information set forth above comes from the tax returns of individual, including self-employed individuals. No information has been provided regarding Roth IRA contributions, since they are nondeductible, and are not reported on the tax Form 1040. We would expect that the IRS will be releasing information from the 2004 5498s relatively soon. ◆

Consequence of Not Explaining a Recharacterization, Continued from page 1

unaware of the requirement to explain a recharacterization when they file their tax return.

A financial institution will want to make certain that anyone recharacterizing a contribution understands the IRS explanation requirement. An easy way to do this is to provide the customer with CWF Form #56-TREX.

Because the IRS will not receive the 2005 Form 5498 showing the recharacterization until May of 2006, it has no way of knowing (in April of 2006) about the recharacterization. By providing a form which the accountholder must sign as an acknowledgement of receipt, the bank may save itself the time and trouble of having to help customers in this situation. ◆

Bank Service Charges, Continued from page 5

Money market accounts are not specifically discussed in the response we received. Money market accounts are special savings accounts; normally, 6 withdrawals per month are allowed from these accounts. The issue is, then, whether it would be considered a checking account (and subject to sales tax on service charges) or whether it would be considered a savings account (and not subject to sales tax on service charges). CWF would hope a money market account would be considered a savings account, but we cannot be sure.

Financial institutions will also need to be aware that any account from which a withdrawal can be made via a written instrument is considered a checking account to which Iowa sales tax applies. ◆

The Percentage Method—Single Life-Expectancy Table

For Use By Beneficiaries

Age	Distribution Period	%	Age	Distribution Period	%
56	28.7	3.4843	84	8.1	12.3457
57	27.9	3.5842	85	7.6	13.1579
58	27.0	3.7037	86	7.1	14.0845
59	26.1	3.8314	87	6.7	14.9254
60	25.2	3.9683	88	6.3	15.8730
61	24.4	4.0984	89	5.9	16.9492
62	23.5	4.2553	90	5.5	18.1818
63	22.7	4.4053	91	5.2	19.2308
64	21.8	4.5872	92	4.9	20.4082
65	21.0	4.7619	93	4.6	21.7391
66	20.2	4.9505	94	4.3	23.2558
67	19.4	5.1546	95	4.1	24.3902
68	18.6	5.3763	96	3.8	26.3158
69	17.8	5.6180	97	3.6	27.7778
70	17.0	5.8824	98	3.4	29.4118
71	16.3	6.1350	99	3.1	32.2581
72	15.5	6.4516	100	2.9	34.4828
73	14.8	6.7568	101	2.7	37.0370
74	14.1	7.0922	102	2.5	40.0000
75	13.4	7.4627	103	2.3	43.4783
76	12.7	7.8740	104	2.1	47.6190
77	12.1	8.2645	105	1.9	52.6316
78	11.4	8.7719	106	1.7	58.8235
79	10.8	9.2593	107	1.5	66.6667
80	10.2	9.8039	108	1.4	71.4286
81	9.7	10.3093	109	1.2	83.3333
82	9.1	10.9890	110	1.1	90.9091
83	8.6	11.6279	111 +	1.0	100.0000