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ALSO IN THIS ISSUE –

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New Law for Roth IRA Conversions in 2010

President Bush has signed the $70 billion tax bill, "The Tax Increase Prevention and Reconciliation Act of 2005."

There is only one IRA change in this tax bill. Under current law, there is a $100,000 modified adjusted gross income limit which applies to the conversion of funds within a traditional IRA, to a Roth IRA. In general, when Roth IRAs were first created, the Democrats did not want to give to the "wealthy" the right to do conversions. Under current law, "wealthy" means any single person or married couple with modified adjusted gross income in excess of $100,000.

This rule has been repealed. There will be no income limitation for conversions for tax years commencing with 2010. This is a very welcome change for those individuals with incomes over $100,000. These individuals have never had the right to convert traditional IRA funds into Roth IRA funds. They will now have the right to do so after December 31, 2009.

Will there be a boom of conversions in 2010?

It is very possible that there will be a larger number of conversions in 2010. First, this will be the first year that those individuals or couples with incomes over $100,000 will ever have been eligible to do a conversion. Second, there is a special incentive to encourage conversions in 2010.

Continued on page 2

May 31, 2006— Deadline for Form 5498 and IRS Penalty Topic

An IRA custodian must file the 2005 Form 5498 with the IRS by May 31, 2006. An IRA custodian is required to furnish this information electronically if it is required to file 250 or more such forms.

An IRA custodian must furnish to each IRA accountholder by May 31, 2006, the fair market value information and the contribution information as set forth on the 2005 Form 5498. There are numerous ways an IRA custodian may comply with this requirement.

It is important to remember that the penalties under Internal Revenue Code sections 6721 and 6722 do NOT apply to the Form 5498. The penalty provisions of Code section 408(i) and 408(l) apply. The penalty for failure to timely file the Form 5498 is $50 per form with no maximum limitation. The IRS does have the authority to waive this penalty if the IRA custodian has a reasonable cause for its failure. Note that there does not appear to be a penalty for preparing a Form 5498 with incorrect information. ◆

New Law for Roth IRA Conversions in 2010, Continued from page 1

What special incentive will apply to encourage people to convert in 2010?

A person who converts his or her traditional IRA in 2010 will be able to elect to include 50% of the conversion amount in their income for income tax purposes in 2011, and the other 50% would be included in income in 2012. That is, no taxes will need to be paid for 2010, which is the year of the conversion.

Example. William Clinton has $200,000 in his IRA. He converts the entire amount on January 3, 2010, and he makes the special election. He will include $100,000 in his income for 2011 and pay tax, at that year's applicable marginal income tax rate, and $100,000 in income for 2012 and pay tax at that year's applicable marginal income tax rate.

Alternatively, if the person does not want to make the special election, he or she is not required to do so.

Example. William Clinton suffered major investment losses in the first part of 2010. Therefore, he decides to convert the $200,000 in his traditional IRA to a Roth IRA, and he does not make the special election, because the $200,000 will be offset by his "losses."

Why 2010?

For those individuals with incomes over $100,000, this law change is very desirable. Waiting until 2010 is better than never having the right to do conversions.

In order to get this bill passed, there needed to be some revenue offset provisions. That is, in order to cover some of the law changes which would lower the tax dollars to be collected, there needed to be some provisions increasing the tax dollars to be collected. Therefore, the above changes were made with the goal that there will be conversions in 2010 which will raise additional tax revenues.

Any change in the laws for annual Roth IRA contributions?

No. There were no changes in the rules as to who is eligible to make an annual contribution to a Roth IRA. The modified adjusted gross income limits ($95,000/$110,000; $0/$10,000, and $150,000/$160,000) continue to apply to annual contributions.

What were the primary tax law changes made by this new law?

1. <u>Capital Gains and Dividends</u>. There is a two-year extension of the reduced capital gains and dividend rates through 2010. Without this tax law change, the special rates would have applied only through the end of 2008. IRS data shows that revenues from capital gains increased by 79% from 2002-2004 after the tax rate on capital gains was reduced from 20% of 15%. IRS data shows that revenues from dividends increased by 35% from 2002-2004 after the tax rate was reduced to a maximum of 15%, whereas before the change, the highest marginal tax rate could have been 39.6%.

2. <u>Alternative Minimal Tax (AMT) Relief</u>. There will be relief in two ways for tax year 2006. There will need to be another tax bill for changes after 2006.

First, claiming various credits can result in a person being subject to the AMT tax under the original law. This provision extends current law which allows most non-refundable personal tax credits to be claimed against the AMT so that individuals and families continue to receive the full benefit of these tax credits.

Second, this provision extends the AMT exemption levels at a higher level than applied for 2005. The new exemption levels are $62,550 for joint filers and $42,500 for single filers.

3. <u>Extension of Section 179 Expensing</u>. Under current law, small businesses may expense up to $100,000 of investments in depreciable assets. That is, they are not required to depreciate their investment cost over many years. A business will be able to expense up to $100,000 in 2008 and 2009.

Without this extension, the expensing limit would have decreased to $25,000 after 2007.

What were some of the proposed law changes which were removed from the final tax bill?

1. The special savers' credit is set to expire at the end of 2006, unless there is a tax bill which extends it. Initial drafts of this bill would have extended it, but such changes were not adopted.

2. The Senate version of this tax bill would have allowed an IRA accountholder to give his or her IRA to a charity with no income taxes owing. This provision was deleted from the final conference version and did not become law. Presumably, the loss to the U.S. Treasury would have been too large. ◆

The Pension Digest

Revised FDIC Brochure on FDIC Insurance Coverage — Unneeded Confusion

The FDIC has revised its brochures explaining the FDIC's insurance coverage of "deposits."

The FDIC has updated its brochure (as of April 2006) which discusses the new increased maximum coverage amount ($250,000) for retirement accounts. In this brochure, the FDIC uses the term "self-directed retirement account," and defines this term as follows:

"A self-directed retirement account is a retirement account for which the owner, not a plan administrator, has the right to direct how the funds are invested, including the ability to direct that the funds be deposited at a specific FDIC-insured bank.

Types of self-directed retirement accounts include traditional and Roth Individual Retirement Accounts (IRAs), Simplified Employee Pension accounts, 'Section 457' deferred compensation plan accounts, self-directed Keogh plan accounts, and self-directed defined contribution plan accounts.

All self-directed retirement funds owned by the same person in the same FDIC-insured bank are added together and the total is insured up to $250,000."

This article focuses on the FDIC's discussion of the new $250,000 coverage limit which applies to the retirement accounts' category. As we all know, there are various insured categories: single accounts, joint accounts, retirement accounts, revocable trust accounts, payable on death accounts, irrevocable trust accounts and employee benefit accounts. <u>The $250,000 coverage limit only applies to the retirement accounts</u>. In general, the $100,000 coverage limit continues to apply to the other categories, including the employee benefit account category.

There may well be unneeded confusion because the general meaning within the IRA industry of a self-directed IRA is one which allows the IRA accountholder to invest in assets <u>other than</u> the time or savings accounts of the IRA custodian. Normally, an IRA accountholder with a self-directed IRA instructs the IRA custodian/trustee to purchase mutual funds, stocks or bonds on behalf of his or her traditional IRA or Roth IRA.

The general rule is that there is no FDIC insurance coverage if a self-directed IRA invests in non-deposit assets. This rule has not been changed. Self-directed IRAs, to the extent the funds are invested in non-deposit instruments, are not FDIC insured. The FDIC does not insure money invested in stocks, bonds, mutual funds, life insurance policies, annuities, or municipal securities, even if these investments were bought from or through an insured bank.

The FDIC, however, as discussed below, has apparently adopted the new position that, in order to be included in the retirement account category, (and be entitled to the new $250,000 coverage limit), the traditional IRA and the Roth IRA, too, must be self-directed.

Retirement Accounts vs. "Self-Directed" Retirement Accounts

The FDIC has changed the title of the category from being retirement accounts to being "self-directed" retirement accounts.

We at CWF believe the FDIC should not have made this change. Depositors and financial institution personnel are going to be confused.

The FDIC has apparently adopted a new position as to how IRAs are insured for FDIC purposes. Previously, the FDIC had adopted the position that the retirement account category was determined by aggregating the following deposits:

(i) traditional IRA deposits;

(ii) Roth IRA deposits;

(iii) Certain section 457 deferred compensation plan deposits; and

(iv) Deposits to any defined contribution plan allowing self-direction by a participant and any self-directed Keogh plan.

The FDIC has now adopted the approach that the self-direction requirement also applies to traditional IRAs, Roth IRAs and certain section 457 deferred compensation plans, in addition to the pension plans.

We have set forth the statutory law (section 1821) below:

"Sec. 1821(a) (Federal Deposit Insurance Act, Sec. 11)

(1) Insured Amounts Payable

(2) Special Rules — Certain Public Funds

Continued on Page 4

Revised FDIC Brochure on FDIC Insurance Coverage, Continued from Page 3

(3) Certain Retirement Accounts

(A) In General—Notwithstanding any limitation in this Act relating to the amount of deposit insurance available for the account of any 1 depositor, deposits in an insured depository institution made in connection with—

(i) any individual retirement account described in section 408(a) of title 26;

(ii) subject to the exception contained in paragraph (1)(D)(ii), any eligible deferred compensation plan described in section 457 of title 26; and

(iii) any individual account plan defined in section 3(34) of the Employee Retirement Income Security Act {29 U.S.C. 1002(34)}, and any plan described in section 401(d) of title 26, <u>to the extent that participants and beneficiaries under such plan have the right to direct the investment of assets held in individual accounts maintained on their behalf by the plan</u>, shall be aggregated and insured in an amount not to exceed $250,000 per participant per insured depository institution.

(B) Amounts Taken Into Account— For purposes of subparagraph (A), the amount aggregated for insurance coverage under this paragraph shall consist of the present vested and ascertainable interest of each participant under the plan, excluding any remainder interest created by, or as a result of, the plan."

Note the underlined portion. This is the provision which imposes the self-directed requirement. The question to be considered is, "Does this self-direction requirement just apply to retirement plans of employers who give their participants the right to self-direct the investment of their account balance and self-directed retirement plans for self-employed individuals as described in (iii), or does it also apply to traditional IRAs, Roth IRAs and certain section 457 deferred compensation plans as described in (i) and (ii)?"

Although this statute could have been written more clearly, we at CWF believe that the self-direction requirement was not meant to apply to traditional IRAs and Roth IRAs. Keep in mind that there is special FDIC pass-through coverage for deposits of pension plans. This special coverage is under the Employee Benefits Category and not the Retirement Accounts category. In general, the standard $100,000 limit does not apply to the deposits of a pension plan. The pension plan receives FDIC coverage of $100,000 for each participant of the pension plan. When certain defined contribution plans (primarily 401(k) plans) started to allow their participants to self-direct the investment of their 401(k) balances, the decision was made to include such investments under the Retirement Account category rather than the Employee Benefit category.

The last part of the underlined portion expressly refers to "individual accounts maintained on their behalf by the plans." That is, it applies to pension plans which have individual accounts. It is not meant to apply to IRAs. The FDIC officials seem to have forgotten that when Congress originally enacted this provision, self-directed IRAs did not even exist.

As a practical matter, most IRAs are self-directed as defined by the FDIC, because the individual instructs which deposit account(s) will be selected for the investment of their IRA funds. However, many IRAs within Trust Departments are managed in the sense that the trust department makes the investment decisions for the individual. It appears that an IRA managed by a Trust Department (with no self direction) may not be entitled to the new $250,000 coverage limit, even if invested in FDIC-insurable deposits, since the Trust Department has made the investment decision, and not the individual. This should not be the result. This type of deposit would be covered under, presumably, the revocable trust category and would only receive the $100,000 limit. Trust Departments will wish to check with their legal departments about this issue.

Summary and Comment. The new FDIC brochure on FDIC insurance coverage for IRAs and other retirement accounts is confusing. According to this new brochure, in order to receive the $250,000 coverage, all retirement accounts, including IRAs, must be self-directed. But self-directed, in this case, means the right to select the time deposit and not the fact that the IRA accountholder can invest in mutual funds or stocks.

Conspicuous by its absence in the brochure is discussion of FDIC coverage for SIMPLE-IRAs. The statutory law as written does not expressly cover SIMPLE-IRAs. In addition, the FDIC has never amended its regulations to discuss SIMPLE-IRAs. It is presumed these accounts are covered under the new $250,000 limit,

Continued on page 5

The Pension Digest

Revised FDIC Brochure on FDIC Insurance Coverage, Continued from Page 4

but, because there is nothing in writing discussing which category of coverage a SIMPLE-IRA would be in, there is some cause for concern. The FDIC definitely needs to provide guidance concerning SIMPLEs, seeing as their past and present brochures are silent on this subject. ◆

Tax-Owing Letters—Helping Your Customers Reply to the IRS

No one likes to receive a letter from the IRS saying the individual owes additional taxes. Many individuals become very distraught when they receive an IRS letter; some even panic! An IRA custodian/ trustee can expect to encounter IRA accountholders who have received such letters because we understand that the IRS has been sending out such letters the last 30-90 days. It may be that some of your customers or clients have received such a letter.

With respect to IRAs, there are two very common reasons for the IRS to send a tax-owing letter. The first reason is that a person tried to claim a tax deduction for their contribution to a traditional IRA and they (or their tax preparer) did not properly determine what amount was deductible, since the individual or his or her spouse was an active participant in a qualified retirement plan. The second reason is that the person failed to report a distribution on his or her federal income tax return. A person's failure to report a distribution from an IRA or pension plan could either be intentional, or could simply be an oversight. The IRS actually does match the amounts from boxes 1 (gross amount) and 2a (taxable amount) on Form 1099-R, with the amounts being reported on lines 15 (distributions from IRAs) and 16 (distributions from pension plans) of the Form 1040. If the IRS receives a Form 1099-R with respect to a taxpayer, the IRS believes he or she owes taxes on the amount shown on the form, unless an explanation is furnished.

The purpose of this article is to discuss a very specific situation for when the IRS is sending its tax-owing letters, but maybe they should not be. If a person withdrew funds from an IRA in November or December of 2004, and then rolled the funds back into the same or a different IRA in January or February of 2005, within the 60-day limit, the funds are not to be taxed, because they were timely rolled over. It appears the IRS is sending its tax-owing letter to these IRA accountholders because the IRS has been furnished a copy of a 2004 Form 1099-R reporting a distribution, but the IRS has not yet been furnished a 5498 showing the rollover, since the 2005 Form 5498s aren't submitted to the IRS until May of 2006.

To be fair to the IRS, it is not known if the person properly indicated on their 2004 tax return that the distribution amount was not taxable because they completed their rollover within 60 days. Remember, a person who has done a rollover is supposed to write "rollover" on line 15 or 16 (as applicable) of Form 1040. Most likely, the IRS has adopted the administrative approach that it will send the letter, even if there is an explanation that there was a rollover, because any IRS letter issued prior to June of 2006 means the IRS has not yet been furnished the 2005 Form 5498, which would confirm the fact that a rollover had been made in January or February of 2005.

Example: An IRA accountholder withdrew $50,000 from his IRA at Bank #1 in early December of 2004. In January of 2005, the individual rolled the entire amount back into the same IRA at Bank #1. The bank correctly prepared the 2004 1099-R, showing the distribution of the $50,000. The individual showed the $50,000 on line 15a and "0" on line 15(b) of his 2004 Form 1040. On May 15, 2006, the IRS sent this individual a tax-owing letter saying he owes $7,500, plus interest and penalties. He has come to the bank wondering what is going on, and asking if things couldn't have been done differently so the IRS would not have sent the assessment letter.

This is a situation which could affect many IRA custodians/trustees in the next few months. Customers in this situation will probably be very upset to think that they owe additional tax — they may also think the bank is somehow at fault. You will need to explain to your customers that the IRS does not yet have the 2005 5498 information which would indicate that a rollover was made.

Because the 2005 Form 5498, which will report the rollover of the funds back into the IRA within the allowed 60-day period, will not be prepared until May

Continued on page 6

Tax-Owing Letters—Helping Your Customers,
Continued from page 5

of 2006, the IRS has no knowledge of the rollover. Therefore, the IRS believes the taxpayer owes income tax on the $50,000. All the taxpayer needs to do is to provide the IRS with documentation showing that the rollover was completed. A letter from the IRA custodian/trustee should be sufficient, as would a copy of the 2005 Form 5498. Because the funds were rolled back into the IRA in a timely manner, no taxes are owing on this distribution.

This is a quirk in the reporting system to which there really is no solution — there is nothing the bank or the customer can do to prevent the IRS from comparing the 2004 Form 1099-R, (showing that a distribution was taken) to a taxpayer's 2004 Form 1040, and noticing the amount shown on the 1099-R was not reported as taxable income on the return. When a distribution is taken from a traditional IRA late in one year, and rolled over in a timely manner, but not until the following year, this situation exists, until the IRS is furnished the 5498 information for such year.

We at CWF believe the IRS could make this situation easier on themselves, and easier on the taxpayer by providing a box on the IRS assessment letter which the taxpayer could check to indicate that the reason for not claiming the amount as a taxable distribution on their tax return is because the entire amount was rolled over in a timely manner (within 60 days of the distribution). The IRS could then keep such letter until the applicable Form 5498 was generated and compare the two to ascertain that the funds were indeed rolled over, and that no portion of the distribution was taxable. ◆

Can Marriage Work to Retroactively Disqualify a First-Time Home Buyer?

No. 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. ◆

Updating SIMPLE Plans — Deadline Extended

SIMPLE plans were required to be updated on or before December 31, 2002, using the IRS Form 5305-SIMPLE or Form 5304-SIMPLE. This topic was addressed by CWF in the August 2002 newsletter. The article was titled, "Amending SEP-IRA, SAR-SEP and SIMPLE-IRA Plans and Related IRAs and SIMPLE-IRAs."

In reviewing these SIMPLE plans, the IRS has found that many were not updated as required. Fortunately, the IRS has granted relief, and has extended the updating deadline to December 31, 2006.

The penalty for not updating in a timely manner is that the employer and the participants could lose all the retirement savings and tax benefits for which they believed they had qualified. If you find that some of your employer customers have not amended their SIMPLE plans, they will want to be sure to use the IRS Model form revised as of August of 2005.

CWF has prepared an amendment for the individual participant (CWF forms 940, 941, 942 —SIMPLE-IRA agreements), to incorporate the Katrina changes and the FDIC change.

Terminating a SIMPLE Plan

CWF has never seen anything in writing from the IRS concerning the termination of a SIMPLE plan. A business which sponsors a SIMPLE-IRA plan will want to execute a written document stating it is terminating its sponsorship of the SIMPLE-IRA plan. The business doesn't want to assume that the plan is considered terminated just because it has decided to quit making elective deferrals or matching contributions. If the business has any common-law employees, it must communicate the fact that the plan has been terminated, before the start of the year. The effect of the termination is that no one is authorized to make elective deferrals, and that the employer will not be making any matching contributions.

The SIMPLE-IRA funds may be directly rolled over to an IRA after two years from the first contribution. Most employers and employees will desire to take this course of action. ◆

Duty to Notify of Excess HSA Contribution

In some limited situations, the HSA custodian is required to notify the HSA account owner that an excess contribution has been made and it needs to be corrected by withdrawal. In most situations, it is the duty of the HSA account owner and the tax advisor to make the determination that an excess contribution has been made.

The maximum HSA contribution for 2006, for a person who has family coverage is $5,450, if the person has not attained age 55 as of December 31, 2006, and is $6,150, if the person is older than age 55 and such person has not enrolled in medicare.

In order to limit what an HSA custodian must do with respect to monitoring HSA contributions, the IRS has stated that it is permissible to accept any contribution amount as long as such amounts do not exceed the above limits. That is, the IRS does not require the HSA custodian to monitor whether the HSA owner has family coverage or single coverage or what the deductible limit is under the HDHP. The HSA custodian is allowed to accept any contribution up to the $5,450 and the $6,150 limit without regard to the individuals' deductible limit or whether they have single or family coverage. Those are tax determinations. For example, the HSA custodian may accept a contribution of $4,000 from a person who is age 45, since it is less than $5,450.

Once an HSA custodian is advised by an HSA owner that he or she has made an excess contribution, the HSA custodian is obligated to assist in calculating the income associated with the excess contribution. In general, the standard iRA concepts apply. In an upcoming newsletter article, we will be addressing the calculation of the income associated with excess HSA contributions. Such calculations are more difficult, because unlike with excess IRA contributions, there usually have been numerous distributions which have taken place by the time the HSA account owner determines he or she has made excess contributions. ◆

Form 5498 Reporting for IRA Contributions Made After April 17, 2006

As you may or may not be aware, the IRS extended the IRA contribution deadline for individuals affected by Hurricane Katrina.

The IRS newsroom web site for March 22, 2006 states:

> "Deadlines for affected taxpayers to file returns, pay taxes and perform other time-sensitive acts falling on or after March 11, 2006, and on or before May 15, 2006, have been postponed to May 15, 2006."
>
> "Taxpayers considered to be affected taxpayers............include individuals who live, and businesses whose principal place of business is located, in the covered disaster area. Taxpayers not in the covered disaster area, but whose books, records, or tax professionals' offices are in the covered disaster area, are also entitled to relief."

CWF believes this would encompass IRA contributions. Also, we do not believe an individual has to prove that they had storm damage; they merely must reside in the applicable county.

CWF has written to the IRS asking how IRA contributions made after April 17, 2006, are to be reported on Form 5498. Their response is that they currently have no guidance on this reporting issue.

CWF would suggest two approaches:

1. The custodian/trustee would use the standard procedure of reporting any contribution made during the period of 4/17/06 - 5/15/06 as a 2006 contribution, even though it was designated for 2005. You would then need to inform your IRA accountholders that that is how the bank is handling the situation and why, and the individual should enclose an explanation with his/her 2005 and 2006 tax returns. Otherwise, accountholders who made additional 2006 contributions could end up with an excess contribution situation in the eyes of the IRS.

2. If you have not yet issued the 2005 Form 5498, the bank could prepare the 5498s for those individuals taking advantage of the May 15, 2006 deadline, as you would have the necessary information. If you have already sent in the 5498 reporting, you could prepare corrected 5498s.

The problem with approach #2 is that the IRS has NOT said that this is a permissible approach.

In any case, the IRS specifically states in its 3/22/06 newsroom article, that postponement of time to file, by the IRA custodian/trustee, does not apply to the 5498 information returns.

CWF will keep you informed concerning this issue. ◆

Disclosure Statement Requirements

As you are aware, an IRA Disclosure Statement and Projection Schedule must be furnished to anyone opening an IRA at your financial institution. These documents must meet IRS standards for providing this information, or the custodian/trustee may be assessed penalties for noncompliance.

It is important that the projection schedule furnished to your customers accurately reflects the interest being paid, as well as any fees which may be assessed against the account. For example, an annual maintenance fee of $25, must be reflected in the projection schedule.

For traditional IRA's, a projection schedule must be provided covering the projected amount at the end of the first five years, and at the end of the year for ages 60, 65, and 70.

If an individual is age 70½ or older, the only contributions which would be allowed to be made to his or her IRA would be rollover contributions, transfer contributions or SEP contributions. On a projection schedule for someone age 70½ or older, the "rollover" amount of a one-time deposit of $1,000 would be used in the calculation. The only exception to this would be a SEP contribution.

For Roth IRAs, even though contributions are allowed after age 70½, there is no requirement that a Roth projection schedule be modified to include additional ages. It is permissible to use the same projection schedule which applies to traditional IRAs. However, there also is no rule prohibiting extending a Roth projection schedule to include additional ages, providing it is accurate.

If the bank imposes an early withdrawal fee, it must be clearly defined, and the projection schedules must reflect such fees. The IRS may assess a $50 penalty for not furnishing a proper financial disclosure. Failing to define the fee is the type of error for which the IRS could assess the $50 penalty. ◆