THE Pension Digest

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ALSO IN THIS ISSUE –

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

SIMPLE IRA Summary Description— Due by October

What are a financial institution's duties if it is the custodian or trustee of SIMPLE IRA funds? After a SIMPLE IRA has been established at an institution, it is the institution's duty to provide a Summary Description each year within a reasonable period of time before the employees' 60-day election period. CWF believes that providing the Summary Description 30 days prior to the election period would be considered "reasonable." The actual IRS wording is that the Summary Description must be provided "early enough so that the employer can meet its notice obligation." The employer is required to furnish the summary description before the employees' 60-day election period.

IRS Notice 98-4 provides the rules and procedures for SIMPLEs. This notice is reproduced on page 17-80 of CWF's 2005 IRA Procedures Manual. If you do not have this resource manual, an order form is enclosed for your convenience.

As you are probably aware, the employer may complete either Form 5305-SIMPLE (where all employees' SIMPLE IRAs are established at the same employer-designated financial institution) or Form 5304-SIMPLE (where the employer allows the employees to establish the SIMPLE IRA at the financial institution of their choice). No matter which of these forms are completed, the financial institution which is the trustee

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IRS Issues New Reporting Guidance for Mistaken HSA Distributions

A common reason for a mistaken HSA distribution is that the individual's insurance company reimburses them for the same expenses which the individual had paid with his/her HSA funds. The HSA owner then desires to repay such mistaken distribution. In the 2005 Instructions for Forms 1099-SA and 5498-SA, the IRS was silent on how mistaken distributions were to be treated when they were repaid. The 2006 instructions contain the following new guidance concerning this subject.

"Mistaken Distributions. If amounts were distributed during the year from an HSA because of a mistake of fact due to reasonable cause, the account owner may repay the mistaken distribution no later than April 15 following the first year the account owner knew or should have known the distribution was a mistake. For example, the account owner reasonably, but mistakenly, believed that an expense was a qualified medical expense and was reimbursed for that expense from the HSA. The account owner then repays the mistaken distribution to the HSA.

Under these circumstance, the distribution is not included in gross income, is not subject to the 10 percent additional tax, and the payment is not subject to the excise tax on excess contributions. Do not treat the repayment as a contribution on Form 5498-SA.

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SIMPLE IRA Summary Description,
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of any SIMPLE IRA funds is required to furnish the Summary Description. Even though an institution may only have a relationship with the individual accountholder and not the employer, a relationship between the institution and the employer is created simply because the funds are deposited by the employer into the individual's SIMPLE IRA.

There is also what is termed a "transfer" SIMPLE IRA. If your institution has accepted a transfer SIMPLE IRA, and there have been no employer contributions, then there is no duty to furnish the Summary Description. However, if there is the expectation that future contributions will be made to this transfer SIMPLE IRA, then the institution will have the duty to furnish the Summary Description.

The penalty for not furnishing the Summary Description is $50 per day.

The law actually states that the Summary Description must be furnished by the financial institution to the employer. The employer then completes the Summary Description and furnishes it to each eligible employer. However, the IRS has issued written guidance (Notice 98-4) which allows an institution to furnish the Summary Description to the individual employee, instead.

If an institution furnishes the Summary Description to an employee, it must include:

- ✔ A current 5304-SIMPLE — this could be filled out by the employer, or it could be the blank form
- ✔ Instructions for the 5304-SIMPLE
- ✔ Information for completing Article VI (Procedures for withdrawal) (You will need to provide a memo explaining these procedures.)
- ✔ The financial institution's name and address.

The trustee should also provide guidance to either the employer or the employee concerning the need for the employer to complete the first two pages of the form and the provision that it must be distributed to all eligible employees. Obviously, if an institution provides the employee with a blank form, he/she will need to have the employer complete it, and, the employee may well need to remind the employer that it needs to provide the form to all eligible employees.

CWF has created a form (reproduced on page 8) which covers the approach of the Summary Description being provided directly to an employee.

Additional Reporting Requirements —

The trustee must provide each SIMPLE IRA account holder with a statement showing the account balance as of 12/31 of each year (this is the same as for the traditional IRA), and include the activity in the account during the calendar year (this is not required for a traditional IRA). There is a $50 per day fine for failure to furnish this statement (with a traditional IRA, it would be a flat $50 fee). ◆

IRS Issues New Reporting Guidance,
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As the trustee or custodian, you do not have to allow owners to return a mistaken distribution to the HSA. However, if you do allow the return of the mistaken contribution, you may rely on the account owner's statement that the distribution was in fact a mistake. See Notice 2004-50, Q/A 76, which is on page 196 of Internal Revenue Bulletin 2004-33 available at www.irs.gov/pub/irs-irbs/irb04-33.pdf. Do not report the mistaken distribution on Form 1099-SA. *Correct any filed Form 1099-SA with the IRS and the account owner as soon as you become aware of the error.* See Corrected Returns on Paper Forms in the 2006 General Instructions for Forms 1099, 1098, 5498, and W-2G for more information."

CWF's Comments. According to the above instructions, the HSA custodian is not to report the distribution or the recontribution of a "mistaken" HSA distribution. CWF finds this rather unusual, since the IRS will then have no "paper trail" or record that such distribution and recontribution ever took place, unless the custodian would be audited. Your institution will want to keep excellent records to document the situation where a mistaken HSA distribution was repaid.

Also note that the HSA custodian does not have to allow the recontribution of a mistaken HSA distribution, and that, if they do allow it, they are permitted to rely solely on the HSA owner's statement that the distribution was, indeed, a "mistake." ◆

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Estate as the IRA Beneficiary — Many Times an Unwise Approach

An IRA accountholder will almost always name their spouse as their primary beneficiary. However, many times there will be no "contingent" beneficiaries named, or the individual will name their estate as the contingent beneficiary. Most IRA plan agreement forms provide that the IRA funds are to be paid to the accountholder's estate if he or she did not designate a beneficiary, or if none of the designated beneficiaries are alive at the time of the accountholder's death. The following example and discussion will illustrate why naming the estate as a contingent beneficiary may not be in the best interest of the accountholder and his/her children who will inherit the estate.

Example: Marylee Iken has an IRA with a $250,000 account balance. Her date of birth is 3/13/36. She died on 7/31/06, before her required beginning date (which would have been 4/1/07). She had no surviving spouse. She had listed her spouse as her primary beneficiary, many years ago, and did not change that designation when he died in 2003. She had not named any contingent beneficiaries, so her estate becomes her beneficiary by default. She has one daughter, Ann Hall, age 45, who is the beneficiary of her estate.

The distribution options for Ann, had she been named as a contingent beneficiary, would have been the 5-year rule or the life-distribution rule. However, because the estate is now the beneficiary, by default, the only distribution option is the 5-year rule. The life-distribution rule is only allowed to be used for living beneficiaries. Under the 5-year rule, the total IRA account balance must be distributed by 12/31 of the year containing the fifth anniversary of Marylee's death (12/31/11). The inherited account will need to be entitled, "Estate of Marylee Iken as beneficiary of Marylee Iken's IRA."

Does the estate have to stay "open" until 12/31/11 to accommodate the 5-year rule? Because Ann is the beneficiary of the estate, she will want to seek an attorney's opinion as to whether or not the funds can "pass through" (basically be "transferred") to an IRA entitled, "Ann Hall as Beneficiary of Marylee Iken's IRA." Only on the provision of a legal opinion by an attorney, stating that this is permissible, are the funds allowed to pass through to Ann's inherited IRA. The estate would then be able to be closed. Before an IRA custodian distributes any funds in Ann's name, they will want to be in possession of the attorney's affirmative written pass-through opinion.

Obviously, Ann would have been better off if her mother had named her as the contingent beneficiary. Ann then would have been able to stretch payout of the IRA over her life expectancy. Now she must have the $250,000 totally distributed to her by 12/31/11. Ann can, of course, have any amount she chooses paid to her at any time during this 5-year period, as long as the account balance is zero (0) by 12/31/11. Obviously, this will result in an increased tax burden for Ann, as she will have to include the $250,000 in her gross income over a much shorter time period than she would have if she were allowed to use the life-distribution rule.

Over how many years could Ann have spread distribution if she could have used the life-distribution rule? Since she is 45 years old, her life expectancy is 38.8 years, and her distribution amount would have been $6.443.30 per year, amounting to 2.6% of the IRA account balance. If she were to have equal amounts distributed over the 5-year period ($50,000 per year), it would amount to 20% of the account balance per year, a considerable difference.

Although it is not required, CWF believes it would be good customer service for an IRA custodian to discuss the various beneficiary options with its customers, especially if they wish to name an estate as contingent beneficiary or leave that section of the form blank. The customer should definitely be advised to speak with their legal/tax advisor before making this decision. You will also want to remind customers to review their beneficiary designations and make changes when circumstances such as the death of the primary beneficiary arise. ◆

Beneficiary Situation — Minor Inherits an IRA

If a minor inherits an IRA, do they have the same rights and obligations as an adult? Under the terms of the IRA plan agreement, CWF believes a minor (a child who has not yet reached the age of majority under state law), has the same rights and requirements as any other IRA beneficiary, including the requirement to take a required minimum distribution under the applicable rules.

CWF received a call from a Michigan financial institution, where, in the case of a teenage beneficiary, the state had stepped in and said such child must be appointed a guardian or conservator, to assist the child with his or her financial affairs, including the IRA, to be certain such affairs are handled properly.

How should a financial institution handle the situation of an IRA beneficiary who is under the age of majority? Different states will have different rules addressing this situation. The bank's attorney will need to research state law to see if a guardian or conservator is required to be appointed when a minor inherits an IRA.

Under CWF plan agreements, the minor would have the normal distribution options available to them — the life-distribution rule or the 5-year rule. Because they are not the sole surviving spouse, the "treat as own" option is not available. Also, under either of the two options, the individual is able to withdraw a lump sum of more than the required amount at any time. The only additional requirement is that under the life-distribution rule, at least the RMD amount must be withdrawn each year, and, under the 5-year rule, the entire account must be distributed by 12/31 of the 5th year after the accountholder's death.

Administratively, the IRA custodian should title the account, for IRS reporting purposes, just as it does for any other IRA (i.e. Jane Doe as beneficiary of Mary Doe's IRA), and it need not reference the guardian or conservator. However, the guardian or conservator may be referenced in the mailing address section, since presumably, the forms or statements are being mailed to the guardian or conservator. ◆

Traditional IRA Used to Pay Qualified Educational Expenses

It is permissible for an individual to use traditional IRA funds to pay for the qualified educational expenses of themselves, their spouse, their children and/or grandchildren.

The IRS instructs that a distribution used for educational expenses is to be reported on the 1099-R using Code 1 (before age 59½ and no known exception or on account of .....education expenses...). Note that it is not the duty of the IRA custodian to determine whether or not the funds are used for educational expenses. The distribution will be taxable (unless it contains nondeductible dollars), just as any other distribution from a traditional IRA, and must be included in the accountholder's gross income in the year of receipt. However, when traditional IRA funds are used to pay qualified educational expenses, the 10% additional tax is not imposed on the distribution, even if the accountholder is not yet age 59½.

It is the duty of the accountholder to explain, when filing his or her tax return, why a distribution used to pay qualified educational expenses is not subject to the 10% additional tax. An accountholder will do this by completing IRS Form 5329.

A financial institution is not required to inform the customer that they need to complete Form 5329 to explain why the 10% additional tax is not owing for a distribution used to pay qualified educational expenses, but CWF believes this is a good customer service. CWF's Form #57 contains language concerning the need to complete Form 5329 for such distribution. ◆

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Sometimes Funds Within Roth IRAs Cannot Be Moved to a Traditional IRA

A recent CWF consulting customer had a situation similar to the following. A Roth IRA accountholder established his IRA in June of 2002, with a contribution of $1,500. The accountholder is 61 years old in 2006, but has not yet met the 5-year holding period required before a qualified distribution can be taken from this Roth IRA. The accountholder now wants to change this Roth IRA to be a traditional IRA. Is this permissible?

It is not. Unless the recharacterization rules apply, there is no authority to move funds from a Roth IRA to a traditional IRA.

The conversion rules authorize the movement of funds from a traditional IRA to a Roth IRA, but not vice versa.

The recharacterization rules do not allow a person who made a contribution to a Roth IRA for 2002, to recharacterize it to be a traditional IRA in 2006. The time deadlines which apply to recharacterizing a 2002 contribution have long passed.

The recharacterization rules allow an individual who has made a contribution to a Roth IRA for a given year to recharacterize it to be a contribution to a traditional IRA as long as the transaction is accomplished by October 15 of the year following the year for which the contribution was made.

For example, if the accountholder had established his Roth IRA in 2005, for 2005, he would have until 10/15/06 to recharacterize the contribution to be to a traditional IRA. If he had made the original contribution in 2006, for 2006, he would have until 10/15/07 to recharacterize the contribution to be a traditional IRA. However, because this individual made his original Roth contribution in 2002, for 2002, he is no longer able to recharacterize the contribution to be to a traditional IRA, because the deadline for doing so (10/15/03) has already passed.

Conclusion. The general rule is that funds within a Roth IRA are ineligible to be moved to a traditional IRA via a rollover or transfer. There is the exception for recharacterizations, but time deadlines apply. ◆

Frequently Asked Questions Regarding IRAs

(From the IRS)

Can an individual contribute to a traditional IRA if he or she has other retirement plans?

Yes, individuals can contribute to a traditional IRA whether or not they are covered by another retirement plan. However, they may not be able to deduct all of their contributions, if they or their spouse is covered by an employer-sponsored retirement plan. (Note that contributions to a Roth IRA are not deductible, and income limits apply.) See IRS Publication 590 for further information.

How can an individual convert a traditional IRA to a Roth IRA?

A traditional IRA can be converted to a Roth IRA by:

Rollover — A distribution from a traditional IRA can be contributed to a Roth IRA within 60 days after distribution.

Trustee-to-trustee transfer — The financial institution holding the traditional IRA assets will provide direction on how to transfer those assets to a Roth IRA with another financial institution.

Same trustee transfer — As with the trustee-to-trustee transfer, the financial institution holding the traditional IRA assets will provide direction on how to transfer those assets to a Roth IRA. In this case, things should be simpler, because the transfer occurs within the same financial institution.

A conversion results in taxation of any untaxed amounts in the traditional IRA. Also, the conversion is reported on Form 8606, Nondeductible IRAs.

Can an IRA be rolled over into a qualified retirement plan (e.g., 401(k), profit sharing, etc.)?

An IRA can be rolled over into a qualified retirement plan, assuming the qualified retirement plan has language permitting such rollovers.

Can an IRA accept rollovers from a qualified retirement plan?

Provided the IRA document permits rollovers, almost any type of plan distribution can be rolled over into it.

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Are in-service distributions allowed from an IRA-based plan (e.g., SEP, SAR-SEP or SIMPLE-IRA plan)?

There are no prohibitions on distributions from IRA-based plans. A participant can take distributions at any time. However, in addition to the distribution being taxable, it may be subject to a 10% additional tax, if the participant has not reached age 59½. If the distribution is taken in the first 2 years of participation in a SIMPLE-IRA plan, the additional tax is increased to 25%.

Are hardship distributions allowed from an IRA-based plan?

As in-service distributions are allowed, so are "hardship" distributions, subject to the same conditions.

Must distributions be made to IRA-based plan participants who are over age 70½, if they are still working? What about to the owner of the company?

Both the owner and any employees over age 70½ must take required minimum distributions. Unlike qualified plans (e.g. 401(k), profit sharing, etc.) there is no exception for non-owners who have not retired.

How much must be taken out of an individual's IRA at age 70½?

Required minimum distributions apply each year, beginning with the year the account owner turns age 70½. The required minimum distribution for each year is calculated by dividing the IRA account balance as of December 31 of the prior year by the applicable distribution period or life expectancy by using the Tables in Appendix C of Publication 590. Table I is used by beneficiaries. Table II is for use by owners who have spouses who are both the IRA's sole beneficiary and who are more than 10 years younger than the owner. Table III is for use by all other owners.

If an IRA is cashed in before age 59½, what forms need to filled out?

Regardless of age, the IRA owner will need to file a Form 1040 and show the amount of withdrawal from the IRA. Since the withdrawal was taken before reaching age 59½, unless certain exceptions listed in Publication 590, Individual Retirement Arrangements (IRAs) are met, the IRA owner will need to pay an additional 10 percent tax on early distributions from qualified retirement plans that is reported on Form 1040. A Form 5329, Additional Taxes on Qualified Plans (including IRAs) and Other Tax-Favored Accounts may need to be completed and attached to the tax return.

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

No, the additional 10% tax on early distributions from qualified retirement plans does not qualify as a penalty for withdrawal of savings.

Does the participant request the distribution check directly from the employer or from the financial institution where the IRA-based plan is invested?

The participant will need to contact the financial institution holding the IRA assets. After the employer sends the IRA plan contributions to the financial institution, that institution will have control over the funds.

Can the outstanding loan balance from a retirement plan be rolled over into an IRA and the loan payments made to the IRA instead of the other plan?

IRAs (including SEP-IRAs) do not permit loans. Therefore, repaying a loan balance from one plan by transferring the loan balance and making loan payments to an IRA is not allowed. If this transaction was attempted, the loan would be treated as a distribution at the time of the attempted rollover.

The bank refuses to give a loan from an IRA-based plan — isn't it required to allow loans?

IRAs are the investment vehicles for IRA-based plans. As discussed in the above Q&A, IRAs do not permit loans. So banks aren't allowed to give loans from an IRA.

Are there any restrictions on the things an IRA can be invested in?

The law does not permit IRA funds to be invested in collectibles.

If an IRA invests in collectibles, the amount invested is considered distributed in the year invested. The account owner may have to pay a 10% additional tax on early distributions.

Examples of collectibles: Artwork, rugs, antiques, metals (there are exceptions for certain kinds of bullion), gems, stamps, coins (there are exceptions for cer-

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tain coins minted by the U.S. Treasury), alcoholic beverages, and certain other tangible personal property.

Finally, IRA trustees are permitted to impose additional restrictions on investment. For example, because of administrative burdens, many IRA trustees do not permit IRA owners to invest IRA funds in real estate. IRA law does not prohibit investing in real estate, but trustees are not required to offer real estate as an option.

Are the basic investment rules different for SEPs and SIMPLE plans?

The basic investment vehicle for each of these plans is an IRA, and the investment restrictions apply equally to all types of IRAs.

Can losses in an IRA be deducted on a participant's income tax return?

No. Neither IRA losses nor IRA gains are taken into account on a participant's tax return while the IRA is on-going. ◆

No Current-Year Contribution Rule for HSAs

Many of the same rules which apply to IRAs also apply to HSAs. This is NOT the case for the "current-year contribution rule."

Commencing in 1987, the law changed so that a contribution to a traditional IRA may or may not be deductible. It depended upon whether or not a person was an active participant in an employer-sponsored retirement plan, and the amount of the person's modified adjusted gross income (MAGI). In many cases, a person does not know what amount he or she is entitled to deduct until after December 31, when they are able to determine their MAGI.

In order to encourage people to make contributions during the period of January 1 to December 31, the IRS created what we, at CWF, call the "current-year contribution rule." This rule, in essence, allows a person to un-do a current-year contribution made for a current tax year, by October 15 of the following year, as if this contribution was an excess contribution. That is, even if the person was eligible to make the contribution, the person is allowed to use the excess contribution rules to withdraw it. These rules require that the person withdraw the contribution (the amount being withdrawn as an excess), as adjusted for any earnings/losses associated with that amount. For purposes of this rule, 2005 is still considered a "current" tax year, since the correction deadline of October 15, 2006, has not yet passed. Obviously, 2006, then, is still considered a "current" tax year, since the correction deadline is October 15, 2007. 2004 and prior tax years are not current tax years, since the deadline has passed.

It must be noted that this special IRA rule DOES NOT apply to HSAs. All annual contributions to an HSA are either eligible to be deducted or eligible to be excluded from income. If an individual is eligible to make an HSA contribution and does so, there is no procedure to "un-do" the contribution, as there is with IRAs.

If an individual makes an HSA contribution and then decides he/she should not have, the funds cannot simply be withdrawn without tax consequences. The result of withdrawing funds from an HSA and not using them to pay qualified medical expenses is that the withdrawn amount is subject to normal income tax, plus a 10% penalty tax. Obviously, it is better for an individual to not make an HSA contribution, than to make it and decide later that he/she needs the funds for something else. ◆

SIMPLE — Summary Description for the 2007 Calendar Year
(Alternative Method)

To: SIMPLE Accountholder
Name ____
Address ____
City __________________________________ State _____ Zip _______________

From: SIMPLE-IRA Custodian

Date: __________________________

Each year, we, as your SIMPLE-IRA custodian, are required to furnish either you or your employer with a legal document called a SUMMARY DESCRIPTION. The furnishing of this summary is to remind you of your rights under the SIMPLE-IRA plan which your employer sponsors. In general, during the period of November 1 to December 31, 2006, you have the right to make or change how much will be deferred or withheld from your paychecks during 2007 to be contributed to your SIMPLE-IRA. In addition, you have the right to change the financial institution at which your SIMPLE-IRA contributions are made.

Your employer has created the SIMPLE-IRA plan it sponsors by executing the IRS Model Form 5304-SIMPLE (Savings Incentive Match Plan for Employees of Small Employers (SIMPLE) — Not for use with a Designated Financial Institution). Our relationship with your employer is very limited. We deposit funds as paid to us by your employer to be contributed into your SIMPLE-IRA. The contribution amount is attributable to your elective deferrals and your employer's matching contributions.

The IRS has authorized two alternatives for us to furnish the 2007 summary description. We may either furnish a completed copy of the Form 5304-SIMPLE to your employer who then is required to furnish you with a copy. Alternatively, we are permitted to furnish you with a blank copy of the Form 5304-SIMPLE and the following information as set forth below. We have chosen to use this alternative method.

1. The current instructions for the Form 5304-SIMPLE;

2. Our name and address as follows:

   Name ____
   Address____
   City ______________________________ State _____ Zip _______________

3. The procedures, (including describing all fees and charges) which govern your withdrawing funds from your SIMPLE-IRA are as follows:

   ____
   ____
   ____
   ____
   ____
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   ____
   ____
   ____

4. A reminder that your employer will need to complete the first two pages of the Form 5304-SIMPLE and to distribute completed copies to all eligible employees. The employer will also need to inform you if it will be making a matching contribution equal to the employees' salary-reduction contributions subject to a percentage limit of 1-3% which the employer will need to define, or a nonelective contribution equal to 2% of employees' compensation.

SIMPLE #918-B/2007 (8/06) Special Insert
For Form 5304 SIMPLE Kit

White — Employer Yellow — Trustee