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# The Pension Digest

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



## Form 1040 Completion for a Qualified Charitable Distribution

An individual receives a Form 1099-R to indicate to the IRS that a distribution has taken place from an IRA (traditional, Roth, SEP or SIMPLE IRA). The 2006 IRS instructions for lines 15a and 15b of Form 1040 state that unless one of the exceptions apply, an individual is to leave line 15a blank (distribution amount), and enter the total distribution amount on line 15b (taxable amount of the distribution). The reason line 15b should be completed with the total distribution amount is because, normally, unless nondeductible contributions have been made to a traditional IRA, or there has been a rollover, any IRA distribution is fully taxable.

There is a new exception to the IRS instructions for years 2006 and 2007 — a qualified charitable distribution (QCD). A QCD is a distribution which is made directly by the trustee of an individual's IRA (other than a SEP or SIMPLE IRA) to an organization eligible to receive tax-deductible contributions (with certain exceptions). In order for an IRA distribution to qualify as a QCD, an individual must have been at least age 70½ when the distribution was made, and the distribution amount must not have exceeded $100,000. In the case of a married couple, each spouse may have a QCD of up to $100,000. The amount of the QCD is limited to the amount that would otherwise be included in the individual's income. If the IRA contains nondeductible contributions, the distribution is first considered to be paid out of otherwise taxable income.

The 2006 IRS instructions for reporting a QCD on Form 1040 state:

> "If the distribution is a qualified charitable distribution (QCD), enter the total distribution on line 15a. If the total amount distributed is a QCD, enter -0- on line 15b. If only part of the distribution is a QCD, enter the part that is not a QCD on line 15b (unless another exception applies to that part of the distribution). Enter QCD next to line 15b."

**CWF Summary:** The IRS appears to have made the instructions for indicating that an IRA distribution is a qualified charitable contribution quite easy. Simply enter the amount of the QCD on line 15a and -0- on line 15b, showing that none of the QCD is taxable. An individual will want to make certain they meet the requirements for making a QCD, especially the requirement that, but for the QCD rule, the funds would be required to be included in income. Also note that the payment (whether by check, electronic transfer, etc.) must be made directly from the IRA custodian/trustee to the qualifying charity; the payment must not be negotiable by the individual. CWF recommends that an individual consult their tax advisor before making a QCD. ◆

# HSA Cost of Living Adjustments for 2007

| Health Savings Account (HSA)/High Deductible Health Plan (HDHP) Chart of HSA & HDHP Limits | 2006 | 2007 |
|---|---|---|
| Maximum HSA Contributions — Single Coverage | $2,700 | $2,850 |
| Maximum HSA Contributions — Family Coverage | $5,450 | $5,650 |
| HSA Catch-Up Contributions (Age 55 & Older) | $700 | $800 |
| Minimum Deductible Limit of HDHP — Single Coverage | $1,050 | $1,100 |
| Minimum Deductible Limit of HDHP — Family Coverage | $2,100 | $2,200 |
| Maximum Out-of-Pocket Expense Limit — Single Coverage | $5,250 | $5,500 |
| Maximum Out-of-Pocket Expense Limit — Family Coverage | $10,500 | $11,000 |

# New Cost-of-Living Adjustments Announced for 2007

The IRS has recently issued new cost-of-living adjustments for IRAs and other tax preferred plans. These adjustments cover modified gross income increases for the Saver's Credit and IRA contributions. Listed in the charts below are the old and the new limits. The first chart is the traditional IRA deduction chart.

**Traditional IRA Deduction Chart**
(Adjusted Gross Income Limits
for Traditional IRA Deductions)

***FULL DEDUCTION — ACTIVE PARTICIPANT***

| Year | Single | Married Filing Jointly | Married Filing Separately |
|---|---|---|---|
| | AGI LESS THAN | | |
| 2004 | $45,000 | $65,000 | N/A |
| 2005 | $50,000 | $70,000 | N/A |
| 2006 | $50,000 | $75,000 | N/A |
| 2007 | $52,000 | $83,000 | N/A |

***PARTIAL DEDUCTION — ACTIVE PARTICIPANT***

| Year | Single<br>AGI BETWEEN | Married Filing Jointly<br>AGI BETWEEN | Married Filing Separately<br>AGI BETWEEN |
|---|---|---|---|
| 2004 | $45,000 - $55,000 | $65,000 -$75,000 | $0 - $10,000 |
| 2005 | $50,000 - $60,000 | $70,000 - $80,000 | $0 - $10,000 |
| 2006 | $50,000 - $60,000 | $75,000 - $85,000 | $0 - $10,000 |
| 2007 | $52,000 - $62,000 | $83,000 - $103,000 | $0 - $10,000 |

***NO DEDUCTION — ACTIVE PARTICIPANT***

| Year | Single | Married Filing Jointly | Married Filing Separately |
|---|---|---|---|
| | AGI GREATER THAN | | |
| 2004 | $55,000 | $65,000 | $10,000 |
| 2005 | $60,000 | $70,000 | $10,000 |
| 2006 | $60,000 | $75,000 | $10,000 |
| 2007 | $62,000 | $103,000 | $10,000 |

***NOT ACTIVE PARTICIPANT — SPOUSE ACTIVE PARTICIPANT***

**Married Filing Jointly**

| Year | AGI LESS THAN | |
|---|---|---|
| 2004 - 2006 | $150,000 | **Full deduction** |
| 2007 | $156,000 | **Full deduction** |

| | AGI BETWEEN | |
|---|---|---|
| 2004 - 2006 | $150,000 - $160,000 | **Partial deduction** |
| 2007 | $156,000 - $166,000 | **Partial deduction** |

| | AGI GREATER THAN | |
|---|---|---|
| 2004 - 2006 | $160,000 | **No deduction** |
| 2007 | $166,000 | **No deduction** |

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## New Roth IRA Limits

The following charts show the change in the adjusted gross income limits for years beginning in 2004, through 2007, for Roth IRA contribution eligibility. It appears these amounts will be adjusted annually for the cost of living. Until now, there has been no change in the Roth AGI limits since the inception of the Roth IRA.

**Roth IRA Contribution Chart**
(Adjusted Gross Income Limits for Roth IRA Contributions)

***FULL CONTRIBUTION***

| Year | Single | Married Filing Jointly | Married Filing Separately |
|---|---|---|---|
| | AGI LESS THAN | | |
| 2004 | $95,000 | $150,000 | N/A |
| 2005 | $95,000 | $150,000 | N/A |
| 2006 | $95,000 | $150,000 | N/A |
| 2007 | $99,000 | $156,000 | N/A |

***PARTIAL CONTRIBUTION***

| Year | Single | Married Filing Jointly | Married Filing Separately |
|---|---|---|---|
| | AGI BETWEEN | AGI BETWEEN | AGI BETWEEN |
| 2004 | $95,000 - $110,000 | $150,000 -$160,000 | $0 - $10,000 |
| 2005 | $95,000 - $110,000 | $150,000 -$160,000 | $0 - $10,000 |
| 2006 | $95,000 - $110,000 | $150,000 -$160,000 | $0 - $10,000 |
| 2007 | $99,000 - $114,000 | $156,000 -$166,000 | $0 - $10,000 |

***NO CONTRIBUTION***

| Year | Single | Married Filing Jointly | Married Filing Separately |
|---|---|---|---|
| | AGI GREATER THAN | | |
| 2004 | $110,000 | $160,000 | $10,000 |
| 2005 | $110,000 | $160,000 | $10,000 |
| 2006 | $110,000 | $160,000 | $10,000 |
| 2007 | $114,000 | $166,000 | $10,000 |

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## New HSA Limits

For Health Savings Accounts (HSAs), in 2007, the maximum contribution for an individual with single coverage the lesser of the annual deductible under the HDHP, or $2,850. The maximum contribution for family coverage is the lesser of the annual deductible under the HDHP, or $5,650.

For calendar year 2007, an HDHP is one with an annual deductible that is not less than $1,100 for self-only coverage, or $2,200 for family coverage, and annual out-of-pocket expenses do not exceed $5,500 for self-only coverage, or $11,000 for family coverage. ◆

## Medical Savings Accounts Limits

For Medical Savings Accounts (MSAs) in 2007, an HDHP for self-only coverage is one with an annual deductible of not less than $1,900, and not more than $2,850, with out-of-pocket expenses not to exceed $3,750. For family coverage, the annual deductible must not be less than $3,750 and not more than $5,650, with out-of-pocket expenses not to exceed $6,900. ◆

## IRA Contribution Deadline and Patriot's Day Provide Extended Tax Deadline

Because the normal tax filing and IRA prior-year contribution deadline of April 15, 2007, fall on a Sunday, and because Patriot's Day falls on Monday, April 16, 2007, taxpayers residing in the states of Maine, Maryland, Massachusetts, New Hampshire, New York, Vermont, and the District of Columbia, will be allowed an additional two days to file their 2006 federal income tax returns and make IRA contributions for the prior year (2006). The 2006 tax-filing and IRA contribution deadline for taxpayers residing in these states will be April 17, 2007.

For 2007, for taxpayers in all other states (where April 16, 2007, is not a holiday), the deadline to file 2006 federal income tax returns and to make IRA contributions for the prior year (2006) will be April 16, 2007, because April 15 falls on a Sunday. ◆

## Saver's Tax Credit Limit for 2007

The Saver's Credit was first allowed for tax year 2002. For those taxpayers who qualify, this tax credit allows such taxpayers to greatly reduce their tax liability. However, this is the first time the adjusted gross income amounts used to determine the applicable credit percentage have been increased. The increased amounts will allow a greater number of taxpayers to take advantage of this credit. This credit is in addition to the gross income deduction allowed for a contribution to a traditional IRA. Although no gross income deduction is allowed for a Roth contribution, the Saver's Credit also applies with respect to Roth IRA contributions. To claim this credit, a taxpayer will need to complete Form 8880 "Credit for Qualified Retirement Savings Contributions" and attach it to his or her federal income tax return. ◆

**Saver's Credit —2006**
**ADJUSTED GROSS INCOME**

| Joint Return | | Head of Household | | All Other Cases | | Applicable % |
|---|---|---|---|---|---|---|
| Over | Not Over | Over | Not Over | Over | Not Over | |
| $ -0- | $30,000 | $ -0- | $22,500 | $ -0- | $15,000 | 50% |
| $30,000 | $32,500 | $22,500 | $24,375 | $15,000 | $16,250 | 20% |
| $32,500 | $50,000 | $24,375 | $37,500 | $16,250 | $25,000 | 10% |
| $50,000 | | $37,500 | | $25,000 | | 0% |

**Saver's Credit —2007**
**ADJUSTED GROSS INCOME**

| Joint Return | | Head of Household | | All Other Cases | | Applicable % |
|---|---|---|---|---|---|---|
| Over | Not Over | Over | Not Over | Over | Not Over | |
| $ -0- | $31,000 | $ -0- | $23,250 | $ -0- | $15,500 | 50% |
| $31,000 | $34,000 | $23,250 | $25,500 | $15,500 | $17,000 | 20% |
| $34,000 | $52,000 | $25,500 | $39,000 | $17,000 | $26,000 | 10% |
| $52,000 | | $39,000 | | $26,000 | | 0% |

## Nondeductible Contribution = Roth Contribution

**Question:** When is the making of a nondeductible traditional IRA contribution the equivalent of making a Roth IRA contribution?

**Answer:** When an individual immediately converts the traditional IRA contribution to a Roth IRA via a Roth conversion contribution.

### Contributions Made in 2010 or Later

In order to illustrate the above situation, let's review a typical situation. Ann (age 46) has modified adjusted gross income (MAGI) of $130,000 in 2010; she is a participant in her company's 401(k) plan. Ann is not married. Because of her income, she is ineligible to make a $5,000 contribution (or whatever the then-current maximum contribution amount is) to a Roth IRA. However, she will be eligible to contribute the maximum allowed contribution to a traditional IRA as a nondeductible contribution. Ann can then immediately convert the contribution to be Roth IRA funds. This is the equivalent of making an annual Roth IRA contribution.

### Contributions Made from 2006 - 2009

Assume the same factual situation applies to Ann for years 2006 - 2009. As noted above, because of her income, she is ineligible to make a Roth IRA contribution for these years. She will be eligible to contribute $5,000 to a traditional IRA as a nondeductible contri-

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bution. She cannot do a conversion during these four (4) years, since the eligibility rule still applies (income must be less than $100,000). However, in 2010, she will be able to make a conversion of the aggregate balance in her traditional IRA account. Although it will be fours years before Ann can make the conversion, (beginning January 1, 2010), having made the nondeductible contributions for these four years is virtually the same as having made Roth IRA contributions.

**Might the Tax Laws Be Changed Again?**

New tax laws are always being enacted, and existing tax laws are certainly subject to change. Individuals can only act on the law as currently written, being aware that it may change at some point in the future. Therefore, the recently-enacted law giving all traditional IRA accountholders the right to convert their traditional IRA funds to a Roth IRA in 2010, could be changed. It may be possible that an income limit could once again be imposed — probably one higher than the existing $100,000 conversion limit.

**What Is the Historical Background for the Various Income Limits?**

Current tax laws were designed to discriminate against persons with higher incomes. Because the tax benefits of the Roth IRA are so great — total exclusion from tax of the income earned by the Roth IRA — certain members of Congress did not want highly-compensated individuals to have the right to tax-free IRA earnings. Congress wanted such individuals to be required to pay taxes on their IRA earnings. Therefore, certain individuals are eligible to make annual contributions to a Roth IRA, and certain individuals are ineligible. The 1997 tax law was written so that a person with income in excess of the following amounts, as based on filing status, are ineligible to make a Roth IRA contribution for years 1998 - 2006.

| Filing Classifications | Modified Adjusted Gross Income |
|---|---|
| Married, Filing Jointly | $160,000 |
| Married, Filing Separate Returns | $10,000 |
| Single and Head of Household | $110,000 |

Note the extreme "marriage penalty" imposed on a person who is married, but who does not want to file a joint income tax return. In general, a person who files a joint return becomes liable to pay the taxes owed by the other spouse, regardless of whether or not they are aware that such taxes are owing.

Certain individuals are eligible to make Roth conversion contributions from their traditional IRA to a Roth IRA, and certain individuals are ineligible. The 1997 tax law was written so that a person with income in excess of the following amounts, as based on filing status, are ineligible to make traditional IRA-to-Roth IRA conversion contribution for years 1998 - 2006.

| Filing Classifications | Modified Adjusted Gross Income |
|---|---|
| Married, Filing Jointly | $100,000 |
| Married, Filing Separate Returns | $0 |
| Single and Head of Household | $100,000 |

In 1997, Congress decided that they did not want any person (or couple, if married) with MAGI over $100,000 to be able to make a conversion contribution.

**Example of the marriage penalty:** (1) Juan earns $99,999.99; Mary earns $99,999.99. Their combined income is $199,999.98. Juan and Mary live together, but are not married. Juan and Mary may each make a Roth IRA conversion contribution. (2) David earns $50,000.01; his wife, Ann, earns $50,000. Their MAGI is $100,000.01. They are ineligible to make Roth IRA conversions contributions, since they have exceeded the $100,000 income limit.

Also note the extreme "marriage penalty" imposed on a person who is married, but who does not want to file a joint income tax return. Such individual is totally ineligible to make a Roth IRA conversion contribution.

The Roth IRA conversion eligibility rules will be repealed as of January 1, 2010. All traditional IRA accountholders will then be eligible to make conversion contributions to a Roth IRA. Participants of 401(k) plans and other pension plans, who are entitled to a distribution, will also be entitled to make conversion contributions to a Roth IRA. It is certainly possible that a new Congress and a new President might change these tax rules again. ◆

## Warning — Wrong Rollover Advice Being Circulated

This article is being written because of recent consulting calls received by CWF. We have received calls asking if it is permissible for a nonspouse IRA beneficiary to roll over or transfer inherited IRA funds to the beneficiary's own IRA. The callers have stated that they have been told by their clients that this is an allowed transaction.

CWF does not know who is making such a statement or what they are citing as the authority for this conclusion, but we do know that this is not a permissible transaction. A nonspouse IRA beneficiary has never had rollover rights, and with respect to inherited IRA funds, recent changes do not authorize such rollover.

The supposed purpose of the impermissible rollover or transfer described above would be so that the beneficiary would not be required to take minimum distributions if they were not yet age 70½.

CWF suggests that a financial institution that is approached with this situation simply ask the beneficiary to provide the written authority upon which their information is based, so that it can be reviewed.

It is possible that whoever is circulating this wrong advice is confusing the situation with the new law under which a nonspouse beneficiary of a qualified plan may roll over the inherited funds to their own IRA. Financial institutions will want to differentiate between inherited IRA funds and inherited qualified plan funds which have been directly rolled over to an inherited IRA. You will need to require sufficient documentation indicating the source of any inherited funds. It is permissible to transfer funds from an inherited IRA at one custodian to an inherited IRA at a different custodian. ◆

## Qualified Plan Issues in a Divorce Situation

When a qualified plan participant is involved in a divorce, what issues may the plan administrator face?

State law will govern the terms of the divorce. The plan administrator should be aware that a court may negotiate the individual's pension funds during the property settlement, and in doing so, may dictate that a portion be given to the spouse. However, any order from the court must qualify as a Qualified Domestic Relations Order (QDRO). The court has the jurisdiction to allocate a portion of the funds in the individual's pension plan to the individual's spouse, if the QDRO requirements are met.

Once a purported QDRO is received, it is the duty of the plan administrator to determine whether or not the court order meets the requirements of a QDRO

Definition of Domestic Relations Order — A judgement, decree, or order that relates to the provision of child support, alimony payments or marital property rights to a spouse, former spouse, child or other dependent of a participant, and is made pursuant to a state domestic relations law, including a community property law.

Definition of Qualified Domestic Relations Order — A Domestic Relations Order which creates or recognizes the existence of an alternate payee's right to, or assigns to an alternate payee, the right to receive all or a portion of the account balance payable with respect to a participant under a plan.

A QDRO must clearly specify: (1) the name and last known mailing address of the participant and each alternate payee to which the QDRO relates; (2) the amount or percentage of the participant's account balance to be paid to the alternate payee or the manner in which the amount is to be determined; and (3) the number of payments or periods for which the payments are required.

Another issue the plan administrator might face is that the participant may quit making elective deferrals to the plan. This is permissible, as all plans must allow a participant to cease making elective deferrals. However, the plan administrator must be aware that

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the individual cannot again begin to make elective deferrals for a period of six months after ceasing to make such deferrals.

A plan participant going through a divorce may be in financial difficulty, and may approach the plan administrator asking for a hardship distribution from his or her plan assets. The hardship distribution provision of a qualified plan is an exception to the normal rules for receiving a distribution from the plan — separation from service or attainment of age 59½. An employer completes the adoption agreement to either allow or not allow hardship distributions.

If the employer allows hardship distributions, the following rules apply.

1. Hardship is defined as an immediate and heavy financial need where the employee lacks other resources. Hardship distributions are subject to spousal consent, if applicable.
2. The only needs considered to be "immediate and heavy" are: deductible medical expenses of the employee/spouse/dependents, the purchase of a principal residence for the employee, payment of tuition for the next quarter/semester of post-secondary education for the employee/spouse/dependents, or the need to prevent eviction from, or foreclosure on, the employee's principal residence.

Divorce, and any financial hardship associated with it, is not, in itself, a triggering event to enable a participant to receive a hardship distribution. A hardship distribution is only allowed if the requirements listed above are met.◆

## Reminder — Backup Withholding Does NOT Apply to IRAs

It appears from recent consulting calls, that there is some confusion over whether an IRA account is subject to backup withholding.

What is backup withholding? Backup withholding is withholding required by the IRS on certain payments when a payee has not furnished a tax identification number when requested by a payer or the IRS, or did not furnish a correct tax identification number.

Payments EXEMPT from backup withholding:

- **DISTRIBUTIONS FROM ANY RETIREMENT ACCOUNT (INCLUDING IRAS AND ESOPS)**
- Real estate transactions, foreclosures and abandonments
- Cancelled debts
- Distributions from Archer MSAs
- Long-term care benefits
- Fish purchases for cash
- Unemployment compensation
- Qualified tuition program earnings

For a more complete listing of exempt payments, see the instructions for Form W-9.

Payments SUBJECT to backup withholding:

- Interest payments (Form 1099-INT)
- Dividends (Form 1099-DIV)
- Patronage dividends, but only if at least half the payment is in money (Form 1099-PATR)
- Rents, profits, or other gains as indicated on Form 1099-MISC.
- Commissions, fees, or other payments to independent contractors (Form 1099-MISC)
- Payments by brokers (Form 1099-B)
- Certain payments by fishing boat operators (Form1099-MISC)
- Royalty payments (Form 1099-MISC)
- Certain gambling winnings (Form W-2G)

The payer is to withhold backup withholding when:

- The payee fails to furnish a tax identification number (TIN) to the payer
- The payee fails to certify, under penalty of perjury, that the TIN is correct
- The IRS notifies the payer to withhold because the payee furnished an incorrect TIN
- For interest and dividend account payments, a payer is notified that the payee is subject to backup withholding
- For interest and dividend account payments, a payee fails to certify to the payer that he/she is exempt from backup withholding.

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Reminder — Backup Withholding,
Continued from page 7

The IRS sends a payer Form CP2100 for large-volume submitters, or IRS Form CP2100A for all other filers. It will be accompanied by a listing of missing or incorrect TINs. An entity must begin backup withholding immediately upon receipt of this notice, and must make up to three solicitations (initial, first annual, second annual) asking that it be provided the TIN. Otherwise the institution could be subject to a penalty for failing to include a TIN on an information return.

The current rate of backup withholding is 28%, for payments made after December 31, 2002, and through December 31, 2010; the rate thereafter will be determined at that time. Once backup withholding has begun, and institution must continue until the payee provides a correct TIN. Backup withholding is to be deposited using the same rules as those for employment taxes.

Once the payer provides a correct TIN by completing Form W-9, an entity may cease backup withholding unless the IRS sends another notice. If a second notice is sent by the IRS, an entity must begin backup withholding immediately, and must continue until the IRS notifies the entity by IRS letter 147C or SSA Form 7028. Amounts withheld under backup withholding are not to be refunded to the payee. A financial institution or other entity will reflect the withheld amounts on Form 1099-MISC; the payee will get credit for the withholding, just as employees get credit for the taxes withheld from their paychecks.

If an entity is required to withhold backup withholding and fails to do so, it is liable for the amount which should have been withheld, unless the payee provides Form 4669 stating that they have included the payment on their tax return.

**Summary.** Although payments from IRAs and pension plans are not subject to backup withholding, a financial institution will want to aware that some interest and dividend accounts may be subject to such withholding. The financial institution will want to understand the IRS Notice and what it is required to do, to avoid any possible liability for not remitting backup withholding when required to do so. More information on backup withholding can be found at the IRS web site, www.irs.gov. ◆

## IRS — Confusing 1099-R Instructions

It was brought to CWF's attention that the IRS had significantly changed the instructions as to how to complete box 2a of the 2006 Form 1099-R. The IRS issued the 2006 1099-R and instructions in late September of this year. CWF, along with, we assume, many other companies and financial institutions printed the 2006 instructions as first issued.

For many years, the IRS instructions have said complete boxes 1 and 2a with the same amount — the gross amount of an individual's IRA distributions, and check the "Taxable amount not determined" box.

On the instructions first issued for the 2006 Form 1099-R, it said, "Report the total amount distributed from a traditional IRA or SEP IRA in box 1, and leave box 2a blank. Check the "Taxable amount not determined" box. "

When this was brought to our attention by an IRA custodian, we were very surprised, as the IRS had not noted on the first page of the instructions under "What's New," that the instructions for completing box 2a had changed. Leaving box 2a blank with respect to all distributions from traditional IRAs would have been a major policy change and would have required major modifications in IRA software.

We were set to call the IRS to see what the ramifications would be if financial institutions completed the box in the old way, when we noticed a "revised" set of instructions had been issued in October, 2006. These instructions did not note what had changed from the instructions which were first issued, but they did say to complete box 2a the "old" way — with the same amount as box 1.

Apparently someone at the IRS caught the error. However, this situation could cause serious reporting problems if financial institutions do not know about the error, and try to do their 2006 reporting according to the instructions which were first issued. ◆