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The Pension Digest

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

How Many 5498s Must Be Prepared?

CWF has had numerous questions concerning which accounts may be combined on a 5498, and which cannot. We have found that some software vendors' programs prepare 5498s based solely on SSN, and not whether the account is a traditional IRA, Roth IRA, or inherited IRA.

A common consulting question is as follows. An individual has his own Roth IRA and traditional IRA, and he has inherited a traditional IRA from his mother. For 2005, the financial institution's IRA software prepared two 5498s; one combining the individual's traditional IRA with his inherited traditional IRA, and one for the Roth IRA. They called CWF to confirm that they prepared the correct number of 5498s in 2005 for this customer. Unfortunately, they did not. IRS rules require the financial institution to prepare three (3) Forms 5498.

The rule is that a 5498 must be prepared for each IRA for which there is a plan agreement. Obviously, then, there must be a 5498 for an individual's Roth IRA and another for an individual's traditional IRA. An inherited IRA can never be combined with an individual's personal IRA. We are not surprised that often a software vendor will simply aggregate all IRAs with the same SSN onto one 5498, as most programmers are not IRA experts, and do not know that this is impermissible.

How does the bank correct this 2005 error? They must correct the 5498 on which the individual's traditional IRA and inherited traditional IRA were combined, and they must prepare an original 5498 for the IRA for which no 5498 was separately prepared. The inherited IRA should have the distinct title of "John Doe as beneficiary of Jane Doe's IRA," to indicate that it is, indeed, an inherited IRA, and is separate from the individual's own traditional IRA.

Financial institutions will want to make certain their software is capable of preparing 5498s correctly. The IRS can assess a penalty of $50 per incorrect 5498. ◆

Spousal Contributions

Under IRA rules, a person must have compensation in order to make an annual IRA contribution. A spousal IRA contribution is an exception to this rule. The basis for a spousal contribution is the person's spouse's compensation along with his or her own compensation, if any. In order to make a spousal contribution, a person must be married as of 12/31 of the year for which the contribution is made.

Additionally, the following conditions must be met by the spouse making the spousal contribution for himself/herself:

- The individual must have his/her own IRA;
- The individual must be under age 70½ as of 12/31 of the year for which the contribution is made;
- The couple must file a joint tax return; and

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- The spouse making the spousal contribution must not have compensation which exceeds that of the other spouse.

In the past, a compensated spouse made the spousal contribution on behalf of a nonworking spouse. Now the lower-income or nonworking spouse makes a spousal contribution for himself or herself based on their spouse's compensation, and their own compensation.

Compensation (earned income) is defined to be wages, salary, professional fees and other amounts received in exchange for personal services rendered. It also includes bonuses, commissions, tips self-employment income and taxable alimony. It does not include interest, dividends, pension payments, deferred payments, social security payments, or rental payments.

A spousal contribution may be made to either a Roth or traditional IRA, or a combination of both, as long as, in aggregate, the annual allowed contribution limit is not exceeded. For 2006 and 2007, an individual younger than age 59½ may contribute $4,000, and an individual age 59½ or older may contribute $5,000. The deadline for making a spousal contribution is the same as for a traditional or Roth IRA contribution — the due date for filing an individual's federal income tax return. This is normally April 15, without regard to extension. For 2006, the deadline is April 17, 2007, because April 15 is a Sunday, and April 16 has been declared a holiday in the District of Columbia, which then applies to all federal deadlines for all states.

If the more highly-compensated spouse is older than age 70½, and the lower-compensated spouse has not yet attained age 70½, the lower-compensated spouse may make a spousal contribution, as long as the eligibility rules are met.

The combined spouses' income limits which apply to spousal contributions are the same as those which apply to traditional and Roth IRAs. ◆

Options if Only a Portion of a Traditional IRA Contribution Is Deductible

What are an individual's options if, when having their 2006 taxes prepared, their accountant tells them they are only eligible to deduct a portion of their traditional IRA contribution (made in 2006, for 2006)? What can be done with these "nondeductible" dollars?

There are three options for individuals in this situation —

1. Leave the dollars in the account as a nondeductible contribution (basis). Using this option means that the individual will need to complete Form 8606 for the first year a nondeductible contribution is made to establish their "basis," and for any subsequent year, if the original nondeductible amount changes either because of contributions or distributions. If the individual is already in distribution, the 8606 must be completed each year, as a portion of the amount distributed will be nondeductible dollars, thus reducing the amount of nondeductible dollars remaining in the account.

2. Recharacterize the nondeductible amount, along with any related earnings, to be a Roth IRA contribution, assuming the individual is eligible to make a Roth IRA contribution.

3. Take out the nondeductible portion of the contribution, along with any related income. This related income will be taxable income to the individual in 2006.

Once the funds are withdrawn, the individual may be able to make a Roth IRA contribution for himself or herself, if eligible. If married, the couple should determine if the other spouse will benefit by making either a traditional IRA contribution or a Roth IRA contribution.

Example: Anna made a $5,000 2006 IRA contribution to her traditional IRA on 9/10/06. Because Anna turns age 70½ in 2007, this will be her last traditional IRA contribution. Her husband, Tom, is retired, and had no W-2 or self-employment income in 2006. Upon having their taxes done, Anna and Tom are informed that, because of income limitations, and because Anna is a participant in a pension plan, Anna is only allowed to deduct $4,700 of the $5,000 contribution. Anna had

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wage income of $11,000 in 2006. What should Anna do with the $300 that is not deductible? It is assumed that the $300 had related earnings of $15 from 9/10/06 to the date of withdrawal in 2007.

Under Option #1, Anna would leave the $300 in the IRA as a nondeductible contribution. She will then need to complete Form 8606 to establish the $300 as her "basis" in the IRA, and to provide documentation that this amount will not be taxable when distributed to her at a future time. Because she attains age 70½ in 2007, and must begin required minimum distributions (RMDs) from the IRA, she will need to complete Form 8606 for each future year and attach it to her tax return, as a portion of each RMD will be considered to be from her nondeductible basis. A special formula is used to calculate the nontaxable amount of an RMD.

Under Option #2, Anna can recharacterize the $315 to be a Roth IRA. This must be accomplished by six months from the tax-filing deadline — 10/15/07. The advantage to this option is that the $15 of income may also be transferred to the Roth IRA. The earnings are not required to be withdrawn. In effect, the contribution is treated as if it had originally been contributed to the Roth IRA.

Under Option #3, Anna could simply withdraw the $300 plus the related income of $15 from the account. She will receive a 2007 1099-R reporting the distribution of $315 to the IRS. The $300 is also included in the couple's gross income, because they did not deduct that amount; therefore, they will have to explain to the IRS, via their income tax return, that the $300 withdrawn from the account is not taxable. Only the $15 of earnings will be reported as additional taxable income for 2006. On Form 1040, line 15a will be completed with $315 (the gross distribution), and line 15b (taxable amount) will be completed with $15.

Under Option #3, because Anna's husband, Tom, had no reportable income of his own, he can make a spousal contribution of the $300; in fact, he is eligible to make a deductible traditional IRA contribution in the same dollar amount as Anna — $4,700. For more information, please refer to the article in this newsletter discussing spousal contributions. ◆

IRA Contribution Not Deductible — No Easy Solution

Situation. A customer contributed $5,000 to an IRA in August of 2006. After having his 2006 taxes done by his accountant on March 5, 2007, it was discovered that he could not claim a deduction for the contribution amount. He was not able to deduct it, because his income was too high and he is an active participant in a pension plan. The accountant's advice is to simply use it for a 2007 contribution. Unfortunately, the tax rules are not that simple. The tax rules do allow this individual to withdraw his current-year contribution (plus earnings) and he could then make a 2007 contribution.

Because this individual is within the time guidelines, this $5,000 contribution could be recharacterized to be a Roth IRA contribution for 2006. However, the individual did not want to do this; he wants to simply withdraw the funds and recontribute them in 2007 to his traditional IRA.

The tax rules require the individual to withdraw not only his "excess contribution" amount, but also the related income. This income is taxable to the individual in 2006, and should have been included on his 2006 tax return. Because this individual has already filed his 2006 tax return, he and his accountant will need to decide if the income is an amount large enough to change the individual's tax liability, requiring an amended return to be filed.

Through April 17, 2007, the withdrawal of the funds will be treated as the withdrawal of a current-year contribution. The IRA custodian will want the individual to complete CWF's standard IRA distribution form, Form #57. The reason for the distribution will be Code P (for a contribution made in 2006 and withdrawn in 2007). The IRA custodian will want to use CWF Form #67-WC to calculate the earnings through the date of actual distribution, and provide the individual with CWF Form #67, which explains that the related income is taxable on the individual's 2006 income tax return.

Conclusion. The accountant's advice to simply change the $5,000 to be a 2007 contribution is not a permissible solution under current IRS rules. The funds were deposited in 2006, and there is no legal authority to change the

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deposit to be a 2007 deposit. He must withdraw the $5,000 along with the related earnings. The related earnings were $150, and are taxable on his 2006 tax return. An amended return would need to be prepared and filed if this $150 was not included on his 2006 tax return.

This individual will want to be reasonably certain that he is eligible to make a deductible traditional IRA contribution for 2007 before recontributing these funds, or he will end up in the same situation next year. ◆

Roth Codes for Form 1099-R Explained

Distributions from Roth IRAs are coded somewhat differently than distributions from traditional IRAs on the Form 1099-R. These codes may be confusing not only to the accountholder, but to bank personnel as well. This article will try to explain, in plain English, what information is being provided to the IRS by the use of each code.

Typically, any Roth IRA distribution will be coded either "J," "T," or "Q." For the withdrawal of an excess contribution, an "8" or "P" may be included with "J."

Code Q — qualified distribution from a Roth IRA: This code is used when the custodian knows that the required Roth IRA 5-year holding period has been met, and the distribution is being made for one of three reasons — (1) death of the accountholder; (2) disability of the accountholder; or (3) the accountholder has attained age 59½.

Code T — Roth distribution, exception applies: This code is used when the custodian knows that the required Roth IRA 5-year holding period has NOT been met, and the distribution is being made for one of three reasons — (1) death of the accountholder; (2) disability of the accountholder; or (3) the accountholder has attained age 59½.

Code J: This code is used for an early distribution from a Roth IRA, when either Code T or Code Q does not apply.

Code J8: This code is used for the withdrawal of an excess contribution to a Roth IRA in the same year the excess contribution was made.

Code JP: This code is used for the withdrawal of an excess contribution to a Roth IRA in any year subsequent to the year in which the contribution was made. The IRS advises custodians to explain to payees that earnings on the excess contribution are taxable to the individual in the year the contribution was made (not the year in which it is withdrawn).

Note: In the case of the withdrawal of an excess Roth IRA contribution, the codes do not inform the IRS as to the whether or not the accountholder is age 59½ or older, or if they are younger than age 59½.

Therefore, if the individual is not yet age 59½, they will owe the 10% tax for a premature withdrawal from a Roth IRA. ◆

Nonspouse Roth Beneficiary Options

As all Roth IRA custodians are aware, there is no "70½" distribution requirement for Roth IRAs while the original accountholder is alive. Unlike traditional IRAs, with Roth IRAs, the distribution rules do not change, no matter what the age of the accountholder at the time of death. After a Roth IRA accountholder's death, generally, a nonspouse beneficiary of a Roth IRA has three options: (1) take a lump-sum distribution (2) take distributions under the 5-year rule, or (3) take distributions over his/her life expectancy. If the 5-year Roth IRA holding period has been met by the decedent, any distribution to a Roth IRA beneficiary will be tax free.

CWF believes the most prudent choice, unless the money is desperately needed, is to choose to take distributions over the beneficiary's life expectancy. In this way, the beneficiary can maximize the tax-free earnings feature of Roth IRAs. The dollars left in the account will continue to grow tax free, and will also not be taxed when distributed. Spreading distributions over the life expectancy of a beneficiary will certainly result in a much larger total amount of earnings than if the funds are distributed in a lump sum or over a 5-year period.

Because there are not many ways to accumulate tax-free income, CWF believes Roth IRAs are an excellent investment, and, obviously, the longer the funds remain in the account, the more tax-free income is earned. ◆

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Procedures for Qualified Plan (QP) Terminations for 2006 and 2007

As you know, this is primarily an IRA newsletter. However, when we feel it is necessary, because of its significance, qualified plan subjects are also discussed. Because qualified plan updating has been mandated by the IRS, many institutions are asking if it is necessary to update a plan that is terminating or has already terminated. This article will discuss this subject.

Any plan that was terminated prior to 1/1/2006, does not need to be updated. Any plan that existed as of 1/1/2006, was opened in 2006, or was terminated in 2006, does need to be updated.

In order for qualified plan funds to be rolled over to an IRA because of plan termination, such plan needs to be "qualified" prior to the rollover. This means it must meet IRS requirements for a qualified plan. If updating has been mandated, and the plan is rolled over before it is updated, the plan is not "qualified," and the rollover is not valid, meaning the individual is not eligible to receive the tax benefits associated with a rollover. Funds rolled over from a plan that is not "qualified" (updated) will be taxable to the recipient in the year of the invalid rollover.

The IRS has not yet approved CWF's revised Basic Plan Document and eight adoption agreements. However, because we timely submitted them for approval, it is permissible to use them, meaning an employer can use these documents to update now and terminate their plan. Should the IRS require that CWF make any changes to the documents, the adopting employer will have to simply sign a new document, to incorporate the changes. This will have no effect on the plan termination or distribution of the funds, as the individual will have complied with all necessary requirements. We do not believe the IRS will request further changes, as we have included their previously-requested changes, but there is no guarantee. We just want to make our customers aware of the fact that a terminating employer may have to sign an additional document.

When we update a plan for a terminating plan, Collin W. Fritz and Associates, Ltd. will be listed as the sponsor of the plan prototype, and not the bank. This is so because Collin W. Fritz and Associates, Ltd. (CWF) submitted its plan document filing to the IRS by the January 31, 2006 deadline. We also should have filed the prototype plan document on behalf of our customer banks by January 31, 2006. The practical effect is that an employer must execute an updated plan document showing CWF as the plan sponsor, and then they may terminate their plan.

When the CWF plan document is approved by the IRS, we will send a copy of the approval letter to the bank, and the bank will need to provide it to any terminated employers, for their records. We are hoping this will happen within the next 30-90 days.

When CWF prepares the updated adoption agreement, we also send a "Notice of Intent to Terminate" form for the employer to complete, to document the termination of the qualified plan (Keogh). We also include a Distribution Notice, explaining the distribution options, and an election form to document the distribution from the plan. These items are provided so that an employer has a proper paper trail to document the termination of the QP.

Additional information: The employer (or his/her tax advisor) will also have to complete and file a final IRS Form 5500-EZ for the plan, even if the assets of the plan have never been greater than $100,000. This form is always required to be filed when a plan terminates. If a plan terminated in 2006, a 2006 5500-EZ will need to be filed; if a plan terminated in 2007, a 2007 5500-EZ will need to be filed. We recommend filing this form as soon as possible after the plan is terminated, as the IRS instructions are unclear as to the amount of time an individual is allowed in which to file the 5500-EZ after plan termination.

What should an institution do if it has already rolled over funds from a terminated plan without the plan being updated?

CWF recommends that the plan be updated as soon as possible, then, should an IRS audit discover the invalid rollover, an institution can at least state that the problem was corrected as soon as it was discovered. The IRS still may not consider the rollover valid, but the institution will have done all that it could.

Note: There is no statute of limitations where qualified plans are concerned. If, 20 years from now, it is

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discovered that in 2006, a plan terminated and the funds were rolled over without the plan being updated, and the IRS audited the plan and found the rollover to be invalid, an individual would owe 2006 taxes on the rolled over funds, plus IRS penalties and interest for 20 years.

When do plans that are continuing to be in force need to be updated?

The IRS has not issued a date by which employers must execute updated documents. As with terminating plans, an employer may update right now, using CWF's documents, but, again, if the IRS request any changes to our documents, the employer will have to sign an additional document incorporating those changes. We recommend that an institution wait until CWF receives final approval of the documents before updating these plans.

As discussed above, because we did not file for our banks by the January 31, 2006 deadline, each employer will have to sign two documents; one to make CWF the sponsor of the plan through 12/31/06, and one to again make the bank the sponsor of the plan from 1/1/07 and forward.

CWF will notify our QP customers when the IRS issues the date by which QPs must be updated. ◆

Roth Distribution Reporting — Determining if the Roth 5-Year Holding Period Has Been Met

As all IRA custodians are aware, Roth IRAs have a required 5-year holding period before a qualified distribution may take place. What happens in a transfer or rollover situation, where the receiving custodian does not know how long the Roth IRA has been in existence? The distribution codes for Roth IRAs on Form 1099-R are different depending on whether or not the institution knows if the 5-year period has been met. Is it the custodian's responsibility to determine whether or not the 5-year period has been met?

CWF's Comments. There is limited discussion in the instructions concerning Roth IRA distributions. CWF believes that a custodian only needs to be concerned with the time the Roth IRA has been in their institution, for determining the 5-year period. In fact, the IRS has not made it clear whether or not a financial institution even has the right to look back to the former custodian in order to determine whether or not the 5-year period has been met. In order to determine the 5-year period, a rollover or transfer form could be used which asks for the date the Roth IRA was established, and on which the individual certifies that this information is correct; however, the IRS does not make clear whether or not a successor custodian is allowed to ask for and rely on such a document.

Will the individual have tax problems if the custodian prepares the 1099-R stating that the 5-year period hasn't been met, when it actually has, because the current custodian has only had the account for three years? No, because an individual is always allowed to send proof to the IRS to substantiate their position, no matter how the reporting entity prepares the 1099-R. The individual would complete Form 8606 to indicate that the distribution from a Roth IRA was a qualified distribution.

Conclusion. In CWF's opinion, the current Roth IRA custodian should prepare the 1099-R, as appropriate, only for the time the Roth IRA has been in its possession. Although it may seem like good customer service to try to determine whether or not the 5-year holding period has been met, the IRS has not expressly authorized such action. ◆

Options for a Spouse as a 401(k) Beneficiary

CWF received a call about the following situation. A 401(k) plan participant died; he had designated his wife, age 51, as his sole beneficiary. Because the wife has not yet attained age 59½, she has proposed to her financial institution the idea of rolling over the $250,000 401(k) balance to an inherited IRA. She believes she would then be able to withdraw the funds from the IRA as a beneficiary, and not owe the additional 10% tax.

This individual is not correct in her proposed idea. A spouse beneficiary of a 401(k) plan can roll over the funds to her own IRA, but not to an inherited IRA. If she wishes to avoid the 10% additional tax, she could roll over the funds to her own IRA and then set up a

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substantially equal periodic payment schedule. This schedule would not be eligible to be changed until she attains age 59½.

If this individual needed access to a portion of the funds immediately, she could leave the funds in the 401(k) plan and have the plan make a distribution to her as a beneficiary. This course of action would also avoid her having to pay the 10% additional tax.

The new legislation allowing a nonspouse beneficiary to roll over qualified plan (QP) funds to an inherited IRA, may have led to this person's confusion. A spouse beneficiary has always had the right to roll QP funds into their own IRA. The IRA custodian will need to tell this individual that it cannot accept the rollover of QP funds for a spouse beneficiary to an inherited IRA. The explanation to be made to this individual is simple — the law does not permit such a rollover for a spouse beneficiary. ◆

Unexpected Tax Consequences for Nonspouse IRA Beneficiary

Situation: An IRA accountholder died; he had designated a trust as his beneficiary. The trustee of the trust completed the financial institution's distribution election form, and took a lump-sum distribution of the account — $225,000. He assumed he would be able to roll this amount over into an inherited IRA. This individual was unaware that he would be required to include this lump-sum distribution in income in the year received, and pay taxes on it, because nonspouse beneficiaries have no rollover rights. The financial institution did not use CWF's distribution form. CWF's form clearly states that a nonspouse beneficiary (which a trust obviously is), has no rollover rights.

Although a financial institution is not a tax expert, it should, as a customer service, and to protect itself from any liability, be certain to inform a nonspouse beneficiary that they have no rollover rights. CWF recommends using CWF's Form #204 or #57, and highlighting the language that states this information.

In a situation such as described above, the customer could well argue that the institution should have informed him that, as a nonspouse beneficiary, he could not roll over the distribution from the decedent's IRA account. Even though this is technically not the institution's responsibility, a customer could still sue the institution, and although the court would most likely rule in the financial institution's favor, the cost of defense would be considerable. CWF believes it is in the best interest of both the individual and the bank to make certain that nonspouse IRA beneficiaries are clearly aware that they have no rollover rights.

Some of the confusion in the above situation could be the result of new legislation which allows a nonspouse qualified plan beneficiary to roll such funds into an inherited IRA. Anyone who is not aware of the IRA rules could certainly think that if a nonspouse QP beneficiary can perform such a rollover, why can't a nonspouse IRA beneficiary? The answer is simply that the law does not permit it. ◆

Nonspouse HSA Beneficiary

Situation. An HSA account owner died in the fall of 2006. The custodian of the HSA did not learn of the account owner's death until February of 2007. This individual's two children are her beneficiaries. What is now required of the HSA custodian?

If the beneficiary of the HSA had been the individual's spouse, the decedent's HSA would have become the spouse's HSA as of the date of death. When an HSA beneficiary is not the spouse, the HSA ceases to be an HSA as of the date of death. The instructions for the HSA distribution reporting Form 1099-SA state that nonspouse beneficiaries of an HSA are to include the fair market value (FMV), as of the date of the account owners death, in their income in the year the account owner died, even if such beneficiaries receive the funds at a later date. This means the HSA custodian will need to determine the FMV of the account as of the date of death. The two beneficiaries will need to be informed of the requirement to include their share of this amount in their 2006 taxable income, even though they have not yet received any distribution.

For reporting purposes, Form 1099-SA only needs to be completed when a distribution from the account has taken place. Therefore, if the children have not taken a distribution, no 1099-SA is required for the beneficiaries. If the decedent withdrew funds in 2006 prior to her death, a final 2006 1099-SA would need

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to be prepared. If the funds are distributed equally to the children in 2007, the bank will prepare a 2007 1099-SA to report the distribution. Box 4 will be completed with each child's 1/2 share of the date-of-death FMV. Box 1 will be completed with the gross distribution amount, plus any earnings which may accumulate prior to the actual distribution (any earnings accrued after the date of death are taxable to the beneficiaries). The FMV and the distribution amount may not be the same.

Example: The FMV on the date of the account owner's death was $1,850. The balance in the account as of February 15 was $1,430. Qualifying medical expenses of $400 had been paid from the account and $20 of bank service charges had been assessed against the account. Therefore, the FMV of the account for each beneficiary's 1099-SA will be $925 (the amount they need to claim as income for 2006). Accrued interest through February 28, 2007, equals $15. If the beneficiaries take their distribution on 3/1/07, each will be distributed $722.50 (1/2 of the remaining account balance of $1,430, plus 1/2 of the accrued interest of $15).

Since qualifying medical expenses for the decedent may be paid for up to one year from the date of death, the beneficiaries can reduce their taxable income by the amount of any such medical expenses which they paid.

Besides explaining to the beneficiaries that the fair market value is taxable to them in 2006, the HSA custodian needs to explain that they will not receive the 1099-SA detailing their 2007 distribution until 1/31/08. You will also want to remind them that if they pay additional qualifying medical expenses for the decedent within one year of the decedent's death, they can reduce their FMV by that amount, and thus lower their tax liability. It is not permissible to lower the FMV by the amount of the bank's service fees which have been charged.

CWF will be creating a form which explains the 1099-SA requirements and why the account balance is taxable in the year of death, but yet the 1099-SA is not prepared until the January 31 of the year after a distribution is taken. ◆

For Distributions to a Beneficiary — Use Code "4"

According to the number of consulting calls we receive on the subject, there seems to be confusion as to when to use Code 4 (Death distribution) in box 7 of the Form 1099-R. For any distribution to an inheriting IRA beneficiary, Code 4 is to be used. It does not matter how many years have passed since the accountholder's death; Code 4 is to be used for all distributions to a beneficiary.

Note: Code 4 is <u>not</u> used to inform the IRS that an IRA accountholder has died.

The use of Code 4 appears to have two informational purposes: (1) the IRS is notified that the recipient is an individual who is receiving an IRA distribution because they are the designated beneficiary of a deceased IRA accountholder; and (2) the IRS is informed that the 10% additional tax is not owed, even if the recipient is younger than age 59½.

CWF will be clarifying reason #4 (Death) on its IRA Distribution Form #57, by adding language similar to the following — "for any and all distributions to an inheriting IRA beneficiary." ◆