THE Pension Digest

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ALSO IN THIS ISSUE –

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

IRS Beats Their Mandated Deadline

In addition to making a number of changes to Health Savings Accounts (HSAs), the Tax Relief and Health Care Act of 2006 (TRHCA 2006) mandated the IRS to issue the HSA cost-of-living adjustments (COLAs) by June 1 for subsequent years. Normally the COLAs are issued in the fourth quarter of the year for the next year. Inflation data available as of March 31 is to be used instead of the previous August 31 figures. This only applies to HSAs. IRA and QRP annual COLAs are still expected in the fourth quarter.

That means the 2008 adjustments were required by June 1, 2007 this year. Believe it or not, not only did the IRS meet this deadline, they beat it. On May 14, 2007, IRS Revenue Procedure 2007-36 was issued stating the 2008 limits for HSA contributions and High Deductible Health Plans (HDHPs).

This chart summarizes the limits that take effect for tax-year 2008. Some have changed versus 2007, and some have not.

High Deductible Health Plans

	Minimum Annual Deductible		Maximum Annual Out-of-Pocket Expenses	
	2007	**2008**	**2007**	**2008**
Single Coverage	$1,100	$1,100	$5,500	$5,600
Family Coverage	$2,200	$2,200	$11,000	$11,200

Maximum Contribution Limits

	2007	**2008**
Single HDHP	$2,850	$2,900
Family HDHP	$5,650	$5,800

HSA Catch-Up Contributions

	2007	**2008**
Age 55 and Older	$800	$900

This revenue procedure officially noted the date change for subsequent COLAs. In addition, it reminded taxpayers that HSA contributions are no longer subject to the lesser of the annual deductible and the annual limit. For a detailed explanation of all the HSA changes brought about by the TRHCA 2006, please refer to the December 2006 issue of CWF's Pension Digest. ◆

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When Is an RMD No Longer an RMD?

The answer is, "When the IRA owner dies before his or her required beginning date."

An important year for an IRA accountholder is the year he or she attains age 70½. As we all know, the tax laws require such an IRA accountholder to take a distribution for such year. The deadline for taking this first distribution is April 1 of the following year.

Example. Jane Donovan attained age 70½ on September 15, 2006. You, as her IRA custodian, calculated her RMD amount to be $2,500 for 2006. You sent Jane her 2006 RMD notice in January of 2006. She had informed you that she would like to have $2,500 withdrawn and deposited into her savings account on 3/31/07. You had calculated her 2007 RMD to be $2,800. She had instructed you that she wanted the $2,800 withdrawn and deposited into her savings account on 12/15/07.

Alice Jennings, one of Jane's three children, had recently called to inform you that her mother had died on March 18, 2007. Alice has asked, "Does the RMD for 2006 need to be distributed by April 1, 2007?" She wanted to understand what rules would now apply to her and her two siblings.

Jane died before her required beginning date. In this situation, the IRA regulation states that an RMD is no longer required for either 2006 or 2007, with respect to Jane. The $5,300 is not required to be paid to Jane's estate or to her children, who are her beneficiaries.

Each of the three children will be able to decide whether to use the life-distribution rule (over their life expectancies) or the 5-year rule. If they use the life-distribution rule, the first distribution must be withdrawn by December 31 of the year following the year of death. This would be December 31, 2008, for Alice and her siblings. Although they could elect to start taking distributions in 2007, any such distributions would not be mandatory. ◆

A Very Bad Day

We all have bad days, but a Roth IRA custodian had a really bad day with respect to a Roth IRA distribution. If an error could be made, it was made by the personnel of the Roth IRA custodian.

The purpose of this article is to illustrate how <u>not</u> to handle Roth IRA distributions.

Situation. Jonathan, who is 72 years old, has a Roth IRA at ABC Bank. In December of 2006, the bank calculated and distributed to Jonathan, from his Roth IRA, an RMD check in the amount of $450, with $50 withheld for federal income tax withholding. Because Jonathan has multiple traditional IRAs with the same bank, he did not question the distribution nor the withholding at that time, as he normally had withholding on his traditional IRA distributions. In January of 2007, he received a 1099-R from ABC Bank for this 2006 Roth IRA distribution showing the distribution as being taxable. That is, box 2a was completed with the distribution amount rather than being left blank. At that time, he realized that he had been distributed funds from his Roth IRA. Jonathan is not happy and he is concerned about the $50 withholding.

This situation reveals three major mistakes by the Roth IRA custodian.

Mistake #1. As all IRA custodians are aware, no RMDs are required for Roth IRAs, no matter what the age of the accountholder. (RMDs do apply to inheriting beneficiaries of Roth IRAs.)

Mistake #2. The 1099-R was prepared incorrectly for a Roth distribution.

Mistake #3. The bank withheld $50 for federal income tax purposes; no withholding should have been withheld from a Roth distribution.

What should the financial institution do in this situation?

Corrections —

Mistake #1—Unfortunately, there is no correction available for Mistake #1. Obviously, the 60-day rollover period is long past, so rolling the funds back into the Roth IRA is not an option. If Jonathan had noticed the error in time, he could have rolled the

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funds back into his Roth IRA with no adverse tax consequences. However, because a distribution did actually take place, and the 60-day rollover period has passed, there is no legal authority to correct this distribution. Can the bank simply allow the funds to be returned to the Roth IRA since the distribution was clearly a bank error? No, to do so could be considered fraud and would constitute an excess contribution to the Roth IRA.

Mistake #2—The institution completed the 1099-R as though the distribution was from a traditional IRA, and not a Roth IRA indicating that the distribution is taxable. The incorrect 1099-R was prepared as follows:

Box 1 — $500

Box 2a —$500

Box 4 — $50

Reason Code — 7

Therefore, a corrected 1099-R will need to be prepared as follows —

Box 1 $500 (the gross amount of the distribution ($500).

Box 2a — The IRS instructions indicate that Box 2a is to be left blank for a Roth distribution.

Box 4 — $50 (the amount withheld for federal income tax purposes)

Reason Code — "Q" (qualified distribution from a Roth IRA — because the individual has met the 5-year holding period, and he is older than age 59½)

Although it would seem to make sense to complete box 2a with "0," since it is known that a "qualified" Roth distribution is tax free, that is not what the IRS instructions state.

Mistake #3—Although Jonathan is worried about the withholding issue, it should not be a major issue. If he has no other tax liability, he will receive the total amount which ABC Bank withheld from this distribution ($50) as a federal income tax refund. If he owes taxes, this amount will go toward his tax liability as dollars already paid. Form 8606 does not need to be completed as this form is only completed for nonqualified Roth distributions. On his 1040 federal tax form, Jonathan should complete line 15a with the gross amount of the distribution ($500), and line 15b with "0," (the taxable amount). He will also include the amount withheld ($50) on line 64 of Form 1040 (total taxes withheld as detailed on Forms W-2 and 1099).

IRA custodians will want to be certain their software can differentiate between Roth and traditional IRAs. The financial institution could certainly have liability for the individual's lost earnings in this situation, since he was distributed an amount from his Roth IRA which should not have been distributed. Had the funds remained in the Roth IRA, the earnings would have continued to grow tax free, possibly for many years. ABC bank should also check to make certain that this was an isolated incident, and no other Roth IRAs had RMDs paid out. ◆

Guidelines for Roth IRA Contributions

(IRS Tax Tip 2007-25)

Taxpayers confused about whether they can contribute to a Roth IRA should consider guidelines based on the following categories:

- **Income limits.** To contribute to a Roth IRA, you must have compensation (e.g., wages, salary, tips, professional fees, bonuses). These limits vary depending on your filing and marital status.
- **Age.** There is no age limitation for Roth IRA contributions.
- **Contribution limits.** In general, if your only IRA is a Roth IRA, the maximum 2006 contribution limit is the lesser of your taxable compensation, or $4,000 ($5,000 if 50 or older). The maximum contribution limit phases out depending on your modified adjusted gross income.
- **Spousal Roth IRA.** You can make contributions to a Roth IRA for your spouse, provided you meet the income requirements.
- **Time.** Contributions to a Roth IRA can be made at any time during the year or by the due date of your tax return for that year (not including extensions).

Roth IRA contributions are not tax deductible and are not reported on your tax return. On the other hand, you do not include in your gross income, and therefore are not taxed on, any qualified distributions

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or distributions that are a return of your regular Roth IRA contributions or that are rolled over into another Roth IRA.

For complete information and definitions of terms, get Publication 590, Individual Retirement Arrangements. Visit the IRS web site at IRS.gov, or call 800-TAX-FORM (800-829-3676) to request a free copy of the publication. ◆

Additional IRS Guidance Issued for Flexible Spending Arrangement (FSA) and Health Reimbursement Arrangement (HRA) Rollovers to HSAs

Financial institutions are generally aware that IRA funds may now be transferred tax-free to an HSA. Financial institutions may not be as aware that funds from an FSA or HRA may also be transferred tax-free to an HSA. This article discusses recent IRS guidance on these special transfers. An HSA custodian will be interested in this guidance as there are special rules.

Internal Revenue Bulletin 2007-10, Notice 2007-22, was issued by the IRS on March 5, 2007. It contains additional guidance concerning the rollover of FSAs and HRAs to HSAs, under the general rules of the Health Opportunity Patient Empowerment Act of 2006.

CWF's December 2006 newsletter contained discussion of these new HSA rollover laws. The new rules provide, in limited circumstance, for certain amounts in a <u>health FSA and/or HRA</u> to be rolled over into an HSA, and for such rollover to receive favorable tax treatment. The following discussion is taken from Notice 2007-22.

Generally, under the new rules, all of the following conditions must be satisfied in order to receive the favorable tax treatment:

- By plan year end—
  - The FSA or HRA plan must be amended
  - The employee must elect the rollover
  - The year-end balance must be frozen
- The funds must be transferred by the employer within two and a half months after the end of the plan year and result in a zero balance in the health FSA or HRA.

Under special <u>transition relief</u> provided in this notice for <u>amounts remaining at the end of 2006</u>, however:

- There is no requirement to freeze the year-end balance in the health FSA or HRA, and
- The amendment, election, and transfer must have been completed by March 15, 2007.

General Rules

Section 302(e) of the Act provides for "qualified HSA distributions" before January 1, 2012. A qualified HSA distribution is a direct distribution of an amount from a health FSA or HRA to an HSA. The distribution (rollover to an HSA) must not exceed the lesser of the balance in the health FSA or HRA (1) on September 21, 2006, or (2) as of the date of the distribution. Thus, an individual who was not covered by a health FSA or HRA on September 21, 2006, may <u>not</u> elect a qualified HSA distribution. Similarly, an individual who participated in a health FSA with one employer on September 21, 2006, and participates in a health FSA with a second employer after that date, may not elect a qualified HSA distribution with respect to the second employer's health FSA.

A qualified HSA distribution must be contributed directly to the HSA trustee by the employer. Only one qualified HSA distribution is allowed with respect to each health FSA or HRA of an individual. Qualified HSA distributions are not taken into account in applying the annual limit for HSA contributions. Qualified HSA distributions are treated as rollovers, and, thus, are not deductible.

If the individual fails to remain HSA-eligible during the 12-month testing period following the distribution, the amount of the rollover is included in gross income and is subject to an additional 10% tax. It is not required that an employee be an eligible individual with HDHP coverage in order to have qualified HSA distributions made on the employee's behalf. However, if an employee is not an eligible individual immediately following the qualified HSA distribution, the amount of the distribution is included in the employee's income and subject to an additional 10% tax.

Coverage during a grace period by a general purpose health FSA is disregarded if (1) the balance in the

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health FSA at the end of the prior plan year is zero or (2) the individual makes a qualified HSA distribution of any balance remaining at the end of the plan year to an HSA.

Section 302(b) of the Act only applies to health FSA coverage during a grace period following a plan year. Thus, health FSA coverage during the plan year is not disregarded, regardless of whether the health FSA balance is reduced to zero during the plan year by a qualified HSA distribution or otherwise.

Qualified HSA Distributions

If an employer wants to provide qualified HSA distributions, the employer must amend the health FSA or HSA written plan. In order to comply with the comparability rules in § 4980G of the Code, the amended plan must offer qualified HSA distributions to any otherwise eligible individual covered by the employer HDHP. However, there is no requirement that the health FSA or HRA be terminated in order to provide a qualified HSA distribution. Health FSAs and HRAs must satisfy the nondiscrimination requirements in § 105(h) of the Code.

A qualified HSA distribution may be made at any time prior to January 1, 2012. However, even if the qualified HSA distribution reduces the balance of an FSA or HRA to zero, the health FSA or HRA coverage does not end. If the FSA or HRA is not HSA-compatible, employees can become eligible individuals only after transfers at the end of the plan year of the FSA or HRA that result in either disregarded coverage under 302(b) of the Act, or the termination of the HRA coverage at the end of the plan year. Consequently, qualified HSA distributions from health FSAs or HRAs that are not HSA-compatible and that take place at any time other than the end of a plan year, generally result in the inclusion of the distribution in income and the imposition of an additional 10% tax.

The amendments in the Act do not change the requirement that unused amounts remaining at the end of a health FSA's plan year must be forfeited in the absence of a grace period. Thus, if a health FSA does not have a grace period, unused amounts remaining at the end of the plan year are forfeited and generally cannot be transferred through a qualified HSA distribution to an HSA after the end of the plan year. Although the unused amounts can be distributed to an HSA before the end of the plan year, because the health FSA coverage continues until the end of the plan year, an individual covered by the health FSA is not an eligible individual immediately after the qualified HSA distribution, and thus any such qualified HSA distribution is included in income and subject to an additional 10% tax. Similarly, an individual without HDHP coverage after a distribution is not an eligible individual after the distribution, and, thus, the qualified HSA distribution is included in income and subject to an additional 10% tax.

HDHP Coverage Beginning After the First Day of the Month

An employee who begins HDHP coverage after the first day of the month is not an eligible individual until the first day of the next month. If a qualified HSA distribution is made on behalf of such an employee before the first day of the next month, the employee is not an eligible individual as of the date of the qualified HSA distribution, and the amount of the distribution is included in the employee's income and subject to an additional 10% tax. Thus, if an employee begins HDHP coverage after the first day of the month, any qualified HSA distribution, on behalf of the individual made on or after the first day of the next month, avoids immediate inclusion in income.

Consequences of Failing to Roll Over Entire Balance of General Purpose Health FSA or General Purpose HRA

An employee with a balance in a health FSA with a grace period or HRA at the end of a plan year is an ineligible individual for HSA purposes on the first day of the immediately following plan year. Because the employee is covered under a health plan that is not an HDHP during the testing period, the amount of the qualified HSA distribution is included in the employee's gross income in the year of the distribution and is subject to a 10% additional tax. However, an employee with a balance in the HSA-compatible health FSA or HRA at the end of a plan year remains an eligible individual, if otherwise eligible, regardless of whether a qualified HSA distribution is made.

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Additional Tax for Failure to Remain an Eligible Individual

If an individual ceases to be an eligible individual during the testing period, the amount of the qualified HSA distribution is included in the gross income of the individual and subject to an additional 10% tax. Failing to remain an eligible individual does not require the withdrawal of the qualified HSA distribution, and the amount is not an excess contribution. However, any HSA withdrawal not used for qualified medical expenses is included in income and subject to an additional 10% tax (with certain exceptions), regardless of whether the HSA received a qualified HSA distribution that was previously included in the account owner's income and subject to the additional tax. See § 223(f)(4)(B).

Permanent Rule: Individuals with a Zero Balance in General Purpose Health FSA on the Last Day of the Plan Year

Under the Act, if an individual has a zero balance in a general purpose health FSA, as determined on a cash basis, on the last day of the health FSA plan year, the individual does not fail to be an eligible individual as of the first day of the immediately following health FSA plan year because of coverage during a health FSA grace period.

Permanent Rule: Individuals with a Zero Balance in General Purpose Health HRA on the Last Day of the Plan Year

An individual with a zero balance in a general purpose HRA, determined on a cash basis, on the last day of the HRA plan year, does not fail to be an eligible individual on the first day of the immediately following HRA plan year, so long as (1) effective on the first day of the immediately following HRA plan year, the employee elects to waive participation in the HRA, or (2) effective on or before the first day of the following HRA plan year, the employer terminates the general purpose HRA with respect to all employees, or (3) effective on or before the first day of the following HRA plan year, with respect to all employees, the employer converts the general purpose HRA to an HSA-compatible HRA, as described in Rev. Rul. 2004-45.

Permanent Rule: Plan-Year-End Rollovers from General Purpose Health FSA or General Purpose HRA to HSA

An employee with a balance in a general purpose health FSA with a grace period or general purpose HRA at the end of a health FSA or HRA plan year is treated as an eligible individual for HSA purposes as of the first day of the first month in the immediately following plan year that the individual has HDHP coverage on the first day of the month if:

1. The employer amends the health FSA or HRA written plan effective by the last day of the plan year to allow a qualified HSA distribution,
2. A qualified HSA distribution from the health FSA or HRA has not been previously made on behalf of the employee with respect to that particular health FSA or HRA,
3. The employee has HDHP coverage as of the first day of the month during which the qualified HSA distribution occurs, and is otherwise an eligible individual,
4. The employee elects by the last day of the plan year to have the employer make a qualified HSA distribution
5. The health FSA or HRA makes no reimbursements to the employee after the last day of the plan year,
6. The employer makes the qualified HSA distribution directly to the HSA trustee by the fifteenth day of the third calendar month following the end of the immediately preceding plan year, but after the employee becomes HSA-eligible,
7. The qualified HSA distribution from the health FSA or HRA does not exceed the lesser of the balance of the health FSA or HRA on (a) September 21, 2006, or (b) the date of the distribution, and
8. (a) After the qualified HSA distribution there is a zero balance in the health FSA or HRA, and the employee is no longer a participant in any non-HSA compatible health plan or (b) effective on or before the date of the first qualified HSA distribution the general purpose health FSA or general purpose HRA written plan is converted to an HSA-compatible health FSA or HRA, as described in Rev. Rul. 2004-45, for all participants.

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Transition Rule: Qualified HSA Distributions from General Purpose Health FSA and General Purpose HRA before March 15, 2007

An employee with a balance in a general purpose health FSA with a grace period or general purpose HRA after December 31, 2006, is treated as an eligible individual for HSA purposes as of the first day of the first month in 2007 that the employee has HDHP coverage on the first day of the month if:

1. The employer amends the health FSA or HRA written plan effective on or before March 15, 2007, to allow a qualified HSA distribution,
2. A qualified HSA distribution from the health FSA or HRA has not been previously made on behalf of the employee with respect to that particular health FSA or HRA,
3. The employee has HDHP coverage as of the first day of the month during which the qualified HSA distribution occurs, and is otherwise an eligible individual,
4. The employee elects on or before March 15, 2007, to have the employer make qualified HSA distribution from FSA or HRA to the HSA of the employee,
5. The qualified HSA distribution from the health FSA or HRA does not exceed the lesser of the balance of the respective health FSA or HRA on (a) September 21, 2006, or (b) the date of the distribution,
6. The employer makes the qualified HSA distribution directly to the HSA trustee by March 15, 2007, but after the employee becomes HSA-eligible, and
7. (a) After the qualified HSA distribution there is a zero balance in the health FSA or HRA, and the employee is no longer a participant in any non-HSA compatible health plan or (b) effective on or before the date of the first qualified HSA distribution, the general purpose health FSA or general purpose HRA written plan is converted to an HSA-compatible health FSA or HRA, as described in Rev. Rul. 2004-45, for all participants.

Reporting

Amounts transferred through a qualified HSA distribution are not reported in box 12 of Form W-2. Employers are not responsible for reporting whether an employee receiving a qualified HSA distribution remains an eligible individual during the testing period. However, the employers must report qualified HSA distributions as rollover contributions to the HSA trustee, and the HSA trustee must report the qualified HSA distribution as a rollover contribution on Form 5498-SA.

Effective Date

The provision of the Act allowing qualified HSA distributions from health FSAs and HRAs is effective on or after December 20, 2006, and before January 1, 2012. ◆

When is a Person, Age 70½, Not Required to Take an RMD?

Is a person with a traditional IRA in 2007, who attains age 70½ in 2007, always required to take an RMD for 2007? The answer is, "No."

Example. Karen Odebolt opened her IRA on March 15, 2007. She made a $5,000 contribution for IRA year 2006. She attains age 70½ on November 28, 2007. She is not required to take an RMD for 2007, because she had no balance in her IRA as of December 31, 2006. The IRA regulation provides that there are only two situations when the December 31 balance of the preceding year is adjusted: (1) for outstanding rollovers and transfers, and (2) recharacterizations. The IRA RMD regulation does not require an adjustment for a carryback contribution. ◆

When is an IRA Error a Correctable Error?

This time of the year CWF is often asked whether or not an IRA error is correctable. The answer always is "It depends on the circumstances." Many times the answer is not what the IRA custodian/trustee or accountholder are looking for. Here is a situation where the answer was what both wanted to hear.

Example: An IRA accountholder, Jane, informs the IRA custodian that she has been informed by her accountant that her IRA reporting does not match her tax returns. It seems she established a Roth in 2004, but it is being reported as a traditional IRA. Upon investigation, the IRA custodian discovered that a Roth

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IRA application was correctly completed. The contribution was documented as a Roth contribution, but somehow it made its way into the computer system as a traditional IRA and has been reported that way ever since. CWF was asked if this can be corrected, or must the IRA accountholder amend her tax returns?

Since the Roth IRA documents were completed timely, the Roth IRA contribution for 2004 was received timely, this is a reporting error and is correctable. In fact, it must be corrected.

How is it corrected? It is fairly easy, but also fairly time consuming. The IRS Forms 5498 were originally reported, in error for 2004 and 2005, as a traditional IRA. Since this was discovered before the 2006 Form 5498 was prepared, it did not need to be corrected. It was corrected internally and timely prepared as a Roth IRA. Obviously, if this was discovered after the 2006 filing, they would have needed correcting also.

First, both the 2004 and 2005 Form 5498 must be corrected showing the reported traditional IRA with a zero balance Fair Market Value in Box 5. In addition, for any year that reported a traditional IRA contribution in Box 1, a zero must now be reported. These Forms 5498 will be reported as "corrected." Copies are sent to the IRA accountholder and to the IRS. A separate transmittal, Form 1096 if done manually, is prepared for each year. The corrections can be made electronically or manually. But this is only half of the correction. It eliminates the incorrect traditional IRA reporting but has done nothing about the missing Roth IRA reporting.

A Form 5498 must also be prepared for the Roth IRA for 2004 and 2005. Since these have not previously been filed, they are considered originals, not corrections. The Roth IRA contributions and each year's Fair Market Value are reported in Box 10 and 5, respectively. Again, a separate transmittal is required for each year's Form 5498. Corrections and originals are filed separately, each with their own transmittal.

In addition, since the year-end Fair Market Value statements were also incorrect, showing a traditional IRA instead of a Roth IRA, the December 31, 2004 and 2005 statements need to also be corrected and sent to the IRA accountholder.

Are any penalties possible? There should not be any penalties assessed the IRA accountholder. Once the IRS gets all the corrected copies, her tax returns should agree with the filed information. IRA custodian/trustee penalties could be a different situation, however.

Technically, the situation is this. Fair Market Value statements were not prepared for the Roth IRA for 2004 and 2005. The penalty for this is $50 per failure.

The Roth IRA Form 5498 was not filed with the IRS for 2004 or 2005. Again, the penalty is $50 per failure.

In addition, the Roth IRA Form 5498 was not provided to the IRA accountholder for either year. Another $50 per failure penalty is possible.

And finally, since the Form 5498s that were filed for the traditional IRA were incorrect, a $50 penalty for each year is also possible.

Quick math will show that IRA custodian penalties totaling $400 are possible. However, the IRS may waive the penalty for "reasonable cause." It would seem to CWF, although there is no guarantee, that an error like this, corrected as soon as discovered, would fall under reasonable cause…an ordinary, internal accounting error. The IRA custodian should inform the IRS of this with a letter of explanation sent with the corrections and transmittals. The penalties would likely be lowered, if not fully abated.

NOTE: It is important to remember that the reason the correction is possible in this case is because the Roth IRA documentation was established properly and timely. It truly was an internal IRA custodian error. All the documentation indicated a Roth IRA. Had the documentation instead been for a traditional IRA, the answer is very different. In that case, the IRA owner established a traditional IRA, it was reported correctly, so the mistake is the IRA owner's. There is no IRA custodian error to correct, it stands as a traditional IRA. The IRA accountholder would likely need to amend his/her tax returns to show the traditional IRA instead of the Roth IRA. ◆