The Pension Digest

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ALSO IN THIS ISSUE –

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

IRS Rules Direct Transfer From QP to Inherited IRA Permissible When Participant Died in 2005

We have understood that various IRS representatives had been stating at recent seminars that the only QP beneficiaries who could transfer their "inherited QP balance" into an "inherited IRA" on a tax-free basis were those where the plan participant had died AFTER December 31, 2006. This was not good news for QP beneficiaries.The IRS' rationale for this position was that the Pension Protection Act of 2006 (PPA) did not expressly authorize such a rollover for a person who had died prior to December 31, 2006. The PPA provided that the new rules applied to distributions after December 31, 2006. Presumably, the IRS was considering this portion with the goal in mind of collecting tax dollars quicker than they otherwise would have.

At least one area of the IRS (Employee Plans Technical Group 3) has concluded that the main requirement to be met is that the special transfer must take place after December 31,2006; there is no requirement that the participant must have died after 2006. In Private Letter Ruling 200717023, Ms. Sloan rules that a nonspouse beneficiary of a plan participant who had died in2005 would be able to transfer the "inherited" balance from an employer sponsored retirement plan to an "inherited IRA."

This private letter ruling presents the situation/questions about which everyone is concerned. The plan participant died in 2005, well before December 31, 2006. Even so, the IRS finds the transfer of the QP funds to an inherited IRA will be tax free.

This is certainly good news for beneficiaries of qualified plans and other employer-sponsored plans. Many beneficiaries of QP funds do want to roll over such funds into their inherited IRAs and "stretch" the distribution out over their life expectancy. Many employer plans have been written to require a shorter payout period, e.g. five years or less.

In Notice 2007-7, the IRS makes clear that if certain requirements are met, it is possible for a beneficiary to use the life-distribution rule with respect to payments from the inherited IRA even though the 5-year rule would have had to be used for distributions from the pension plan.

Your financial institution will want to make clear to your customers, prospective customers, etc., that you want their inherited IRA accounts. These accounts most likely will be long-term deposit accounts. They are special accounts because there will need to be an RMD each year. For those of you offering only time deposit accounts, you may well want to devise a special time deposit instrument for such accounts. The fact that an RMD will need to be paid each year should not scare a financial institution to refrain from seeking these deposits or from wanting to maintain such accounts.

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The Facts & Rulings of the PLR 200717023

John Doe died in 2005. He was 68 or 69 at the time of his death. He was a participant in qualified Plan X. At the time of his death he did have a vested account balance. In 2004, he had designated Taxpayer A as his sole primary beneficiary of his account under Plan X. Taxpayer A was not married to John Doe at his death.

The employer sponsoring this plan had made the decision to terminate the qualified plan in 2005. The plan administrator had furnished John Doe with a termination Distribution Form. He had completed it and instructed that he wished to do a direct rollover to IRA #1. He had designated Taxpayer A to be his sole beneficiary of IRA #1. Seventeen days after completing the Termination Distribution Form he died. The direct rollover had not been accomplished because of his death. The other participants of the plan were paid out their benefits. However, the qualified plan was not terminated because of the account balance now belonging to Taxpayer A, the beneficiary of John Doe. The employer has represented that it will amend Plan X to comply with section 829 of the Pension Protection Act of 2006 and the guidance furnished in Notice 2007-7. The making of this special transfer will allow the plan to be terminated.

Section 829(1)(1) of PPA-2006 provides that Code section 402(c) is amended by adding the following new paragraph: "(11) Distribution to Inherited Individual Retirement Plan of Nonspouse Beneficiary." Such law change shall apply to distributions occurring after December 31, 2006.

In general, these provisions authorize a tax-free transfer from the qualified plan to an "inherited" IRA. This inherited IRA will be titled, "Taxpayer A as beneficiary of John Doe." Both the plan amendment and the movement of the funds from the qualified plan to the inherited IRA will take place prior to December 31, 2007. The plan amendment will be accomplished (and effective) on or after 1-1-07. Then the transfer to the IRA from the qualified plan would be accomplished. The RMD amounts for 2006 and 2007 will be paid out to the beneficiary prior to the transfer.

The letter ruling asked the IRS to issue the following letter rulings:

1. That Taxpayer A, as the sole named beneficiary of John Doe's interest in Plan X may directly transfer, by means of a trustee-to-trustee transfer, John Doe's remaining interest in Plan X into the inherited IRA and such transfer is authorized by section 829 of PPA.

2. That the titling of the inherited IRA is consistent with Section 829 of PPA.

3. That Taxpayer A may receive RMDs from the inherited IRA using her single life expectancy beginning no later than December 31, 2008. And that such distributions are consistent with section 829 and Notice 2007-7 as to how the RMDs from the inherited IRA are to be calculated.

The IRS (Frances v. Sloan, Manager of Employee Plans Technical Group 3) concluded that it was correct to issue the rulings as requested. As always, the ruling contains the standard disclaimer that pursuant to Section 6110(j)(3) of the Code that his ruling may be used or cited as precedent. Although a PLR cannot technically be cited as authority, as a practical matter, it can be. This is especially true if the same analytical approach is adopted in a number of PLRs on the same topic. The Equal Protection Provision (Section 1 of Article XIV) of the U.S. Constitution, in general, requires equal treatment of U.S. citizens.

The PLR is certainly good news for QP beneficiaries who wish to do this new type of special transfer. It is good news for financial institutions because these rollovers are now a "new" source of deposits. ◆

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Timing of RMD Distributions

The general tax rule is that the deadline for a required minimum distribution is December 31 of each year. There is, of course, the exception for the year a person attains age 70½. The deadline for such year is April 1 of the following year.

Other than this deadline, how and when the RMD is paid to the IRA accountholder is a matter to be settled between the IRA accountholder and the IRA custodian/trustee.

IRA accountholders should establish a periodic schedule as to when they will be paid their RMD for each year. Many individuals instruct to be paid one distribution each year in November or December. Others take their RMDs early in the year. Others take quarterly distributions.

Set forth below are some simple tax and financial planning tips. Although an IRA accountholder has established a distribution schedule with their IRA custodian/trustee, in some situations it may be desirable to change this schedule.

Tip #1. Make a Special RMD Payout Prior to Death

In some cases, the immediate death of an IRA accountholder can be foreseen. Obviously, in other cases, it cannot be.

In the situation where is is relatively certain that an IRA accountholder (who is over age 70½) will die before year-end, it may be desirable to pay out to the IRA accountholder his or her RMD amount prior to his or her their normal distribution schedule and prior to their death. The goal is to minimize the income taxes owing with respect to the distribution.

Example. Ann Taylor is 81 and she has an IRA with a balance of $45,000. She has been taking only her RMD each year. She had designated her two daughters (Mary Taylor and Kate Anders) to be her designated beneficiaries—each to receive a 50% share. Ann's RMD for 2007 is $2,514. She had set up a schedule with her IRA custodian to have her RMD distributed to her on November 15 of each year. Ann's health is failing. Most likely she will die during 2007. Ann has a lower marginal tax rate than Mary or Kate. In fact, in this example, Ann pays no income taxes with respect to the RMD amount because her income is sufficiently low. They marginal tax rate of her two daughters is 25%.

Ann, or her power of attorney, could well decide it would be best to have the IRA custodian pay her the $2,514 prior to her death. This amount would then be included on Ann's final income tax return. She will not pay any income taxes on it because her income is sufficiently low. This means the daughters will not be required to take any distribution with respect to their inherited IRAs for 2007.

If the RMD amount of $2,514 was not paid to Ann prior to her death, then this amount will need to be paid to Mary (50% of $2,514, or $1,257) and to Kate (50% of $2,514, or $1,257). They will include such amounts in their respective incomes, and their marginal tax rates would apply. After Ann's death, this amount cannot be paid by making the check payable to Ann and putting it into her checking account or an estate account. Of course, to do this would lower the income taxes to be paid, but it would be impermissible under the tax laws as the payment had not been made to Ann prior to her death.

Tip #2. Postpone RMD Payout if Death is Imminent

In some cases, it may be better to have the distribution made to the beneficiaries rather than the accountholders. For example, it is known that the various parties would rather have the income tax on the children's tax returns rather than the parent's.

Example. Johann Davies (age 79) has established his RMD schedule where he is to be paid his RMD for 2007 ($32,000) in two installments—50% on March 31, 2007 and 50% on September 30,2007. It is February of 2007, and Johann is expected to die by the end of July. Johann is in a much higher tax bracket than his two children, who each are to receive a 50% share.

Johann, or his power of attorney, could decide to change his RMD schedule so that he would not be paid any portion of his RMD ($32,000) prior to his death. By doing so, the $32,000 will be included in the incomes of his children rather than on his last tax return. The children would need to withdraw their share by December 31, 2007. ◆

A Hard Tax Lesson — Tax Trap for the Unwary

Timing is everything when it comes to tax matters.

A recent tax court case illustrates that if a person (age 53) wants to be able to claim that she does not owe the 10% additional tax when she withdraws money from her traditional IRA to pay her son's college expenses, then she will have to "match-up" the higher education expenses with her withdrawal. If she fails to do this match-up correctly, she will owe the 10% additional tax.

The Facts

In December of 2001, Taxpayer A paid $18,000 to the college her son was attending. This was for tuition and other educational expenses. Then, in early 2002 in order to help her cash flow situation, she withdrew $19,900 from her traditional IRA. Taxpayer A did not pay any education expenses in 2002. She prepared and filed her 2002 tax return. She included in her income the $19,900, and she completed the Form 5329 stating she had taken an early distribution. However, she did not pay the 10% additional tax on the $19,900 ($1,990) because she thought she qualified for the higher education exception.

The IRS concluded that she owed the additional 10% tax because the expense had not arisen in the same year as the early distribution occurred. The distribution occurred in 2002, whereas the expense had occurred in 2001.

Code section 72(t)(2)(E) provides that a distribution will not be subject to the 10% tax to the extent such distributions do not exceed the higher qualified education expenses for the taxable year. A person withdrawing funds early in the year (e.g. January or February) will need to have current-year expenses in order to qualify for the 10% exception.

The U.S. Tax Court agreed with the IRS. Code section 72(t)(2)(E) requires that the funds which were withdrawn in 2002 must be used to pay 2002 educational expenses and not 2001 expenses. And since there were no 2002 expenses, the 10% tax was owed. Taxpayer A (or her tax advisor) needed to know that she was required to take her IRA withdrawal by December 31, 2001 in order to qualify for the exception. The tax court case was Duronio v. Commissioner. ◆

CWF Announces HSA Webinars for the Consumer

As quickly as Health Savings Accounts (HSAs) are being established, there appears to be a great deal of misconceptions, misunderstandings, and general confusion about...by even those individuals who have already established them.

Consequently, CWF has developed a web-based seminar, a webinar, designed for the HSA owner, not the insurance or HSA provider. Now available for the HSA consumer, a comprehensive, yet basic look at HSAs. This presentation can be made available in a number of ways.

HSA Custodian/Trustees — HSA Custodians/Trustees will be able to sign up for webinar broadcasts that can be shown at the financial institution's own facility. Gather your depositors together, as many as you want, and participate in this complete overview of HSAs. Questions will be accepted throughout the broadcast. The telephone line/computer address will need to be your financial institution's.

EXCLUSIVE Interactive Webinar — Instead of attending the broadcast with a number of different financial institutions, reserve a broadcast for just your offices and branches. Again, invite your depositors to participate at your facilities. We can even customize the presentation to allow for your own presentation on HSAs. Again, the telephone line/computer address will need to be your financial institution's.

In Person, Live Presentation — Instead of receiving the presentation over a computer monitor, the comprehensive slide-show presentation will be in person, at your facility. Again invite your depositors to participate at your facilities. We can even customize the presentation to allow for your own presentation on HSAs.

Webinar Presentation at the Consumer's Home or Office — If your financial institution does not want to make this HSA consumer webinar available through your own facility, pass the invitation on to your depos-

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itors that are interested in, and more than likely confused by, HSAs. They will be able to directly purchase the HSA Consumer Webinar and participate from the comfort and convenience of their home or office. For the direct consumer pricing, it will need to be ordered with a private, personal telephone number/computer address.

Any of these presentations would also be perfect for the employer who wants to better inform his or her employees, whether the employer is thinking about offering High Deductible Health Plans (HDHPs) and HSAs or whether the employer's plan has already started.

For more information call your CWF customer service representative at 1-800-346-3961.◆

Where's the Excess?

Some individuals make contributions to both a traditional IRA and also to their Roth IRA. The annual contribution limit applies. There will be times when a person exceeds the annual limit and so an excess contribution situation exists.

In general, the individual has the right to decide whether he or she will correct the excess contribution by withdrawing the excess amount from the traditional IRA or the Roth IRA. The purpose of this article is to make the point — if the person waits too long, he or she will not have this right. The law defines the excess contribution as being the Roth IRA contribution even though that is not what the person wants.

Illustration. An IRA account holder contributed $4,000 to a traditional IRA in February of 2006 for 2006. In December of 2006, she contributed $300 to a Roth IRA for 2006. She has obviously made an excess contribution of $300. If she is eligible to do it, she would like to correct her excess contribution situation by withdrawing $300 from her traditional IRA (plus the related earnings).That is she will have made a $3,700 contribution to her traditional IRA for 2006 and a $300 contribution to her Roth IRA for 2006.

Whether she is allowed to withdraw funds from the traditional IRA as an excess contribution depends on (1) whether she filed her 2006 income tax return or (2) she has an extension to file her 2006 income tax return.

If she has a tax extension for 2006 or she timely filed the 2006 return, then she will be able to withdraw the $300 (plus earnings) from the traditional IRA. She must do this by October 15, 2007. The earnings would be taxable on her 2006.

However, if she does not have a tax extension or did not timely file the 2006 return, then she is too late. The law then defines the excess contribution as being in the Roth IRA. She would owe the 6% excise tax for 2006. She would need to correct it by withdrawing it or by using it as a 2007 contribution.

Why this result? The Roth IRA law defines the permissible Roth contribution amount as being: the contribution amount ($4,000 or $5,000) as a reduced by the traditional IRA contribution. Remember that a contribution which is corrected under Code section 408(d)(4) is treated as never have been made. Since the permissible Roth IRA contribution is based on the formula ($4,000/$5,000 less the amount of the traditional IRA contributions), this gives the result that any excess contribution will arise in the Roth IRA. In order to obtain the relief of Code section 408(d)(4), the taxpayer must have either obtained an extension or have timely filed her tax return.

This situation presents an interesting situation for the IRA custodian/trustee. It may be surprising, but the IRS has never really defined the procedures to be used by the IRA custodian/trustee when an IRA accountholder claims he or she has made an excess contribution.

The policy which has developed is: if the IRA accountholder certifies to the IRA custodian/trustee that he or she has made a current year contribution (including an excess contribution) and is withdrawing it pursuant to Code section 408(d)(4), then the IRA custodian/trustee may use the appropriate "excess codes." These are the "P" and "8" codes. But as discussed above, Code section 408(d)(4) applies only if the 2006 return was timely filed or if a valid extension applies.

An IRA custodian/trustee, as a member or customer service, may certainly inform the person of the special tax rules which provide for the excess to occur within the Roth IRA unless one is able to withdraw the excess funds from the IRA under Code section 408(d)(4). ◆

IRA/Pension Statistics for 2005 From the 1040 Series of Tax Returns

IRA and SEP/SIMPLE/Keogh Deductible Contributions

31.61 billion dollars were contributed to traditional IRAs, SEP-IRAs, SIMPLE-IRAs and Keogh plans for the 2005 tax year. There was a 12% increase from 2004 to 2005.

Taxpayers made contributions of $19.9 billion to SEP-IRA plans, SIMPLE-IRA plans, and Keogh plans for the 2005 tax year, compared to $18 billion for the 2004 tax year. The percentage of increase was 7.8%. In comparison, taxpayers made contributions of $12.2 billion to traditional IRAs for the 2005 tax year, compared to $10.2 billion for the 2004 tax year. The percentage of increase was a whopping 19.6%. The increase from 2003 to 2004 had been only .7%. The number of contributors to the SEP/SIMPLE/Keogh plans for 2005 was 1.20 million, compared to 1.17 million for 2004. There was an increase of 3%. The number of contributors to traditional IRAs for 2005 was 3.29 million, compared to 3.38 million for 2003.

The average 2005 SEP/SIMPLE/Keogh contribution, per return, was $16,167.

The average 2005 traditional IRA contribution, per return, was $3,711.

Chart A shows that there has been a substantial change (48%) in the total contribution amount (6.8 billion dollars) to SEPs/SIMPLEs/Keoghs over the last five years, and in the average contribution amount. In 2001 the contribution amount was $13.1 billion versus 19.9 billion in 2005.

Chart B shows that although the size of the average traditional IRA contribution has been increasing because of the changes in the contributions limits, there has been little change in the number of contributors. In fact, the number of contributors has decreased slightly.

CHART A — SEP/SIMPLE/Keogh Chart

Year	Contribution Amount	Number of Contributors	Average Contribution
2001	$13.1 billion	1.29 million	$11,048
2002	$16.3 billion	1.19 million	$13,774
2003	$16.9 billion	1.19 million	$14,202
2004	$18.0 billion	1.17 million	$15,385
2005	$19.9 billion	1.20 million	$16,167

CHART B — Traditional IRA Chart

Year	Contribution Amount	Number of Contributors	Average Contribution
2001	$7.41 billion	3.45 million	$2,148
2002	$7.41 billion	3.45 million	$2,148
2003	$10.16 billion	3.46 million	$2,936
2004	$10.20 billion	3.38 million	$3,018
2005	$12.21 billion	3.29 million	$3,711

What was the adjusted gross income (AGI) of those who made SEP/SIMPLE/Keogh contributions?

	Under $15,000	$15,001 to $29,999	$30,000 to $49,999	$50,000 to $99,999	$100,000 to $199,999	$200,000 Or more	Total
Number of Returns	26,463	49,233	102,422	280,264	375,999	363,395	1,197,774
% of Total Returns	2.2%	4.1%	8.6%	23.4%	31.4%	30.3%	100%
Contribution Amt. (in thousands)	$161,234	$241,771	$603,803	$2,461,098	$5,637,383	$10,301,089	$19,406,380
% of Total Contr.	.8%	1.2%	3.1%	12.7%	29.1%	53.1%	100%

CWF Observations

1. $19.9 billion is a lot of money.
2. The number of contributors is 1.2 million. This is only 7.6% of the 15.7 million who showed business or profession net income. This appears to be a fairly “wealthy” target audience.
3. 53% of contributions ($10.3 billion) come from individuals with AGI of $200,000 or more.
4. 82% of contributions (15.9 billion) come from individuals with AGI of $100,000 or more.

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**IRA/Pension Statistics for 2005,
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5. 94.9% of contributions (18.4 billion) come from individuals with AGI of $50,000 or more.
6. The average contribution is $16,167. That was a 5% increase.

What was the AGI of those who made traditional IRA contributions?

	Under $15,000	$15,001 to $29,999	$30,000 to $49,999	$50,000 to $99,999	$100,000 to $199,999	$200,000 Or more	Total
Number of Returns	193,479	499,144	827,374	1,099,055	529,706	144,743	3,293,501
% of Total Returns	5.9%	15.2%	25.1%	33.4%	16.1%	4.4%	100%
Contribution Amt. (in thousands)	$507,621	$1,426,543	$2,711,465	$4,141,298	$2,416,695	$1,003,086	$12,207,511
% of Total Contr.	4.2%	11.7%	22.2%	33.9%	19.8%	8.2%	100%
Average Contributions	$2,623	$2,858	$3,277	$3,768	$4,562	$6,970	$3707

CWF Observations

1. It may be surprising, but almost 16% of contributions come from filers with AGI of less than $30,000.
2. The largest contributors are those with AGI between $50,000 and $100,000. They contributed 34% of all IRA contributions.
3. The next largest group of contributors are those with AGI between $30,000 and $50,000. They contributed 22% of all IRA contributions.
4. The average IRA contribution for 2005, per return, was $3,711.

The Retirement Savings Tax Credit

This credit has now been in existence for four years (2002 - 2005). In order to try to induce individuals with low to moderate incomes to make IRA or 401(k) contributions, a special tax credit was authorized for 2002 - 2006. It was extended and made permanent in PPA.

What was the AGI of those who claimed this credit?

	Under $15,000	$15,001 to $29,999	$30,000 to $49,999	$50,000 to $99,999	$100,000 to $199,999	$200,000 Or more	Total
Number of Returns	315,948	2,462,704	2,586,365	179	0	0	5,365,195
% of Total Returns	5.9%	45.9%	48.2%	0%	0%	0%	100%
Credit Amt. (in thousands)	$75,511	$477,556	$409,890	1%	$0	$0	$962,976
% of Total Credits	7.8%	49.6%	42.6%	0%	0%	0%	100%

CWF Observations

1. Low- to moderate-income taxpayers were able to claim a credit of nearly $1 billion.
2. The average credit per tax return was $180.

3. Note that 5.36 million returns claimed this saver's credit. This is more than the number of returns which showed a traditional IRA contribution (3.33 million). Contributions to a traditional IRA, Roth IRA, 401(k) plan or other elective deferral plan qualify a person for this credit.

4. 49.6% of the credit is claimed by filers with AGI of between $15,000 and $30,000.

The information set forth above comes from the tax returns of individual, including self-employed individuals. No information has been provided regarding Roth IRA contributions or nondeductible traditional IRA contributors, since they are nondeductible, and are not reported on the tax Form 1040. We would expect that the IRS will be releasing information from the 2005 5498s relatively soon. ◆

2004 & 2005 HSA Tax Stats

The following chart of HSA information was issued by the IRS with respect to preliminary data from the 2004 and 2005 federal income tax returns. It will be interesting to see how these statistics will change in 2006 and 2007.

	2004	2005	Percentage Change
Number of Returns	88,100	211,766	140.3
Tax Deduction Amount	$180,186,000	$488,782,000	171.3
Average Claimed Deduction	$2,045	$2,308	12.9

What was the AGI of those who claimed this deduction in 2005?

	Under $15,000	$15,001 to $29,999	$30,000 to $49,999	$50,000 to $99,999	$100,000 to $199,999	$200,000 Or more	Total
Number of Returns	7,906	22,587	29,368	64,290	50,710	36,904	211,766
% of Total Returns	3.7%	10.7%	13.9%	30.3%	24.0%	17.4%	100%
Contribution Amount (in thousands)	$15,544	$30,142	$53,587	$134,317	$133,559	$121,632	$488,722
% of Total Contributions	3.2%	6.2%	11.0%	27.4%	27.3%	24.9%	100%
Average Contributions	$1,966	$1,334	$1,825	$2,089	$2,634	$3,296	$2,308

2004 & 2005 MSA Tax Stats

Eligible individuals may still establish and fund MSAs. With the advent of HSAs, however, the number of MSAs are drastically decreasing as one would expect. There were only 18,931 tax returns filed in 2005 which claimed this deduction, versus 30,883 for 2004. Most likely a similar reduction will take place in 2006.

	2004	2005	Percentage Change
Number of Returns	30,883	18,391	- 40.4%
Tax Deduction Amount	$63,086,000	$40,398,000	- 36.0%
Average Claimed Deduction	$2,042	$2,197	+ 7.6%

Reminder

December 31, 2007, is the deadline for qualified charitable distributions. Payment must be made by 11:59:59 p.m. Presumably, a check mailed by such date and time would meet the deadline. ◆