THE Pension Digest

May 2009
Published Since 1984

ALSO IN THIS ISSUE –

A Major Change in the Rules Governing Modifications to Substantially Equal Periodic Payments, Page 2

A Great Planning Technique for Correcting an Excess Roth IRA Contribution, Page 4

When Must a 5498-SA be Prepared?, Page 5

Preliminary Tax Data – IRA/Pension Statistics for 2007, Page 6

Preliminary HSA Tax Data for 2007, Page 8

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

© 2009 Collin W. Fritz and Associates, Ltd. Copyright is not claimed in any material secured from official U.S. Government sources. Published by Collin W. Fritz and Associates, Ltd. Subscription: $95 per year.

IRS Issues 2010 Indexed Amounts for HSAs

The contribution limits for 2010 will be slightly larger than the 2009 limits. The Treasury Department and Internal Revenue Service issued new guidance on the maximum contribution levels for Health Savings Accounts (HSAs) and out-of-pocket spending and deductible limits for High Deductible Health Plans (HDHPs) that must be used in conjunction with HSAs. These amounts have been indexed for cost-of-living adjustments for 2010 and are included in Revenue Procedure 2009-29, which announces changes in several indexed amounts for purposes of the federal income tax.

High Deductible Health Plans

	Minimum Annual Deductible		Maximum Annual Out-of-Pocket Expenses	
	2009	**2010**	**2009**	**2010**
Single Coverage	$1,150	$1,200	$5,800	$5,950
Family Coverage	$2,300	$2,400	$11,600	$11,900

Maximum Contribution Limits

	2009	**2010**
Single HDHP	$3,000	$3,050
Family HDHP	$5,950	$6,150

HSA Catch-Up Contributions

	2009	**2010**
Age 55 and Older	$1,000	$1,000

In addition, a fiscal year plan that satisfies the requirements for an HDHP on the first day of the first month of its fiscal year may apply that deductible for the entire fiscal year. ◆

A Major Change in the Rules Governing Modifications to Substantially Equal Periodic Payments

On May 11, 2009, the U.S. Tax Court issued a decision in Gregory T. and Kim D. Benz versus Commissioner of Internal Revenue, 132 T.C. No.15, contrary to the IRS' long-standing legal position regarding modifications to substantially equal periodic payments (SEPP's). The Tax Court ruled that Kim Benz, who had established a,substantially equal periodic payment schedule in early 2004 with respect to her IRA did not modify her series of periodic payments when she took out additional funds in 2004 and used them to pay for her son's college education expenses. Consequently, she did not owe the special 10% recapture tax of Code section 72(t)(4) which is owed when a person impermissibly modifies her series of periodic payments. The IRS had argued that the withdrawal of any additional funds resulted in an impermissible modification as long as such withdrawal was not due to death or disability. It did not matter that the reason for the additional distribution also qualified as an exception to the 10% tax.

The Tax Court rejected the IRS position. The Tax Court held that a distribution that satisfies the statutory exception for higher education expenses is not a modification of a series of substantially equal periodic payments. Consequently, the rule prohibiting modifications except in cases of death or disability was not violated.

The Tax Court also stated that any distribution satisfying one of the other exceptions to the 10% tax will also not result in a modification of a series of substantially equal periodic payment and the special 10% tax will not apply. Example, a person who has set up a substantially equal periodic payment schedule with respect to her traditional IRA, but then decides to withdraw $10,000 under the first time home buyer rules would also not be subject to the tax penalties associated with impermissibly modifying her SEPP schedule.

We expect the IRS will soon be issuing guidance whether they will adopt the legal position of the Tax Court or whether the IRS will appeal the Tax Court ruling to see if it can get an appellate court to reinstate its legal position.

What the Practical Effect of This Case? It will impact an IRA custodian/trustee in two ways.

It certainly impacts the preparation of the Form 1099-R. This is discussed below. A financial institution may well have one or more of its clients who has established a SEPP schedule now want to take an additional distribution which would also qualify as an exception to the 10% tax as discussed below. Such clients should be advised that they will need to act on the advice of their tax advisors as the IRS may decide to appeal this decision. The instructions for Form 1099-R provide that if it is known by the IRA custodian/trustee that an IRA accountholder has received a distribution pursuant to a substantially equal periodic payment schedule, then a Code 2 (premature distribution, but exception known) is inserted in box 7. Such instructions also state that the IRA custodian/trustee is to insert a reason code 1 (premature distribution) in box 7 when it knows there has been a modification during the current year of a series of substantially equal periodic payment payments within 5 years of the date of the first payment. For additional guidance on what makes a series of substantially equal periodic payments, the instructions cite Notice 89-25, Revenue Ruling 2002-62 and Notice 2004-15.

Until the IRS changes its Form 1099-R instructions, we recommend that an IRA custodian/trustee continue to follow these instructions notwithstanding the Tax Court's ruling. If necessary, the taxpayer/preparer is able to attach a note of explanation to his or her income tax return stating why the 10% additional tax is not owed.

Background. There is statutory tax law and there is administrative tax law. The IRS has the job of administering the statutory tax laws. Admittedly, this job is not always easy. Many times a statute is not as comprehensive as it should be. The IRS issues various types of guidance with varying degrees of authority. The IRS issues regulations, revenue rulings, notices, announcements, news releases, general counsel memorandums, publications, form instructions, private letter rulings, etc. The IRS in this guidance states its understanding of the statutory law and makes administrative law. This case illustrates that although the IRS is generally right in its understanding of the statutory law, there are times

Continued on page 3

THE Pension Digest

Substantially Equal Periodic Payments,
Continued from page 4

when Tax Court concludes that the IRS' position is wrong. The general rule of Code section 72(t)(1) is that a 10% additional tax is generally owed if a person takes an early (before age 59½) distribution from an IRA or other qualified retirement plan.

It may or may not be surprising, but the statutory law does not define which distributions qualify as being part of a series of substantially equal periodic payments. The statutory law also does not define when a modification of such a series of distributions occurs.

Code section 72(t)(2) states that the 10% additional tax of subsection (1) will not apply to certain distributions.

These are the exceptions. The numbers have increased over the years. There are now 13 exceptions. Some of the exceptions apply only to IRA distributions, some apply only to distributions from employer sponsored plans and some apply to both IRAs and employer sponsored plans. See the related newsletter article.

The public policy is that the 10% penalty tax is not to be imposed on the exceptions for various public policy reasons.

One of those exceptions is set forth subsection (iv). The 10% amount is not owing if the distribution is "part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of such employee and his designated beneficiary."

Code section 72(t)(4) defines the tax consequence if there is a modification in the series of substantially equal periodic payments before the deadline when all modifications are permissible. The tax owed by the individual for the year during which the impermissible modification occurs shall be increased by the 10% tax amount which was not paid in all prior years because of the series and as adjusted by interest for each such deferral period. This 10% recapture tax does not apply if the modification in the series is due to death or disability.

Since the statute neither defined what is a SEPP nor what is a permissible/impermissible modification, the IRS had to try to define these terms. The IRS, in general, has historically viewed the concept of a SEPP skeptically as it reduces the amount available to a person during his or her retirement years. The rules and procedures which the IRS has adopted have been designed to limit the use of this exception.

CWF's Comment. Congress should "correct" Code section 72(t) and define what needs to be defined. There are policy questions which Congress should answer rather than the IRS.

In Section 2.01 of Revenue Ruling 2002-62 the IRS defines three safe harbor formulas for calculating the distribution(s) and such distributions will qualify as being part of a series of substantially equal periodic payments.

In Section 2.02 of Revenue Ruling 2002-62, the IRS defines other rules applying to a series of substantially equal periodic payments. Subsection (e) provides "a modification to the series of payments will occur if, after the first valuation date, there is (i) any addition to the account balance other than gains or losses, (ii) any nontaxable transfer of a portion of the account balance to another retirement plan, or (iii) a rollover by the taxpayer of the amount received resulting in such amount not being taxable."

In this case, the IRS position was, if a person withdraws any funds in addition to the payments due under the substantially equal periodic payment schedule, then an impermissible modification has occurred regardless of the reason for the withdrawal of the additional amount and the 10% recapture tax will apply. However, there are two exceptions. The 10% recapture tax does not apply if the modification in the series is due to the accountholder's death or disability.

Under the IRS position, it does not matter if the additional distribution would qualify for another statutory exception to the Section 72(t) 10% additional tax. The special 10% recapture tax still applies.

The Tax Court did NOT agree. The Tax Court decided it needed to define the forms not defined within the statute. The court's rationale.

1. An IRA accountholder may qualify for more than one statutory exception to the 10% additional tax. If a distribution qualifies for more than one statutory exception, then the IRA accountholder is exempt from the 10% additional tax on the basis of the applicable exception as selected by the IRA accountholder.

Continued on page 4

Substantially Equal Periodic Payments, Continued from page 3

2. The Court addressed the question of what is an impermissible modification. The Court cited In Arnold v. Commission, 111 T.C. 250 (1998) wherein the Court held that an additional distribution that did not qualify for a statutory exception was an impermissible modification to a series of substantially equal periodic payments.

In this case, the additional distribution did qualify for a statutory exception, the higher education expense exception. The Court concluded that the method of calculating the IRA accountholder's annual periodic distribution does not change as a result of the additional distributions for higher education expenses. CWF's comment - the IRA accountholder must have elected either the annuity method or amortization method. Consequently, the Court concluded that since the additional distribution satisfied the statutory exception for higher education expenses there has not been a modification of the series of distributions. Since there has been no modification of the series, the 10% recapture tax of Code section 72(t)(4) is inapplicable since it only applies if there has been a modification.

The Court did not find in the statute or the Conference Reports that Congress intended to disallow all additional distributions from an IRA subject to a series of distributions. The Court also found that Congress had bestowed special treatment (i.e. the 10% tax is not owed) for distributions deserving special treatment.

It will be interesting to see how the IRS responds to this tax court decision. Will the IRS change the 2009 Instructions for Form 1099-R to reflect this decision?

It certainly appears the Court has adopted the rule that an additional distribution from an IRA subject to a series of distributions which qualifies for a statutory exception will not result in an impermissible modification of the series for purposes of the 10% recapture tax. We will keep you informed.

A Great Planning Technique for Correcting an Excess Roth IRA Contribution

It happens. A couple make Roth IRAs contributions for 2 or 3 years. Someone finally figures out that for one or more of these years the couple was ineligible to make some or all of the Roth IRA contribution because of the MAGI limits. The person discovering the error could be the tax preparer, the wife, the husband or the IRS.

Real Life Example. A married couple had made their Roth IRA contributions of $5,000 in November of 2007 for 2007. Both had also made $6,000 Roth IRA contributions for 2008 in April of 2008. Their Roth IRA contributions for 2007 were excess contributions as they had exceeded the 2007 MAGI income limits because of a farm sale. Each spouse was eligible to make their $6,000 Roth IRA contributions for 2008.

In order to discourage individuals from making excess contributions, Code section 4973 imposes a 6% excise tax on an excess contribution. The tax is owed for 2007 unless the excess contribution has been corrected by October 15, 2008. This couple's 2007 tax return had been prepared and filed showing that the excess Roth IRA contributions had been withdrawn by April 15, 2008. In reality, this had not occurred. The couple owes the 6% excise tax for 2007 for each of their $5,000 excess contributions or $600 ($5,000 X 2 X 6%). Presumably, they will or have filed an amended return for 2007.

The 6% excess contribution tax is an annual tax. It is also owed for 2008 with respect to the 2007 excess contributions unless it had been corrected (or deemed corrected) by December 31, 2008. Thus, it appears this couple also owes $600 for 2008.

Can any steps be taken so the 6% excise tax will not be owed for the 2008 tax return even though it is now April of 2009?

The couple's tax preparer suggested the following approach to the couple and the Roth IRA custodian.

Continued on page 8

Each spouse will withdraw $5,000 of his or her 2008 contribution of $6,000 as previously made. Any related income would also need to be withdrawn: By making this withdrawal, each spouse is then treated as having contributed only $1,000 for 2008. Another tax rule provides that a person who has existing excess contributions and who has not made his or her full 2008 contribution, is deemed to have made a contribution for the current year. Thus, each excess contribution of $5,000 for 2007 is now considered to be a 2008 contribution. Consequently, there would be no excess contribution as of December 31, 2008 and no 6% tax is owed.

We agree with the tax preparer's suggestion. Taking out $5,000 of the 2008 contribution in April of 2009 will eliminate the 2007 excess contribution as of December 31, 2008. On page 67 of the 2008 Publication 590, the IRS expressly states that a person who withdraws a current year Roth IRA contribution is treated as if such contribution had never been made.

Keep the above planning technique in mind as a way of eliminating an otherwise owed excess contribution tax.

Historical Background. In 1984 the IRS administratively created what is called the current year contribution withdrawal rule. This rule first applied to traditional IRAs. It permitted a person to make his or her IRA contribution at any time during the current year even though at the time he or she made the contribution it was unknown whether the individual would be able to claim a full deduction for his contribution because of the active participant and MAGI rules, but then later withdraw it so that the original contribution was treated as if it had never been made. This special rule encouraged individuals to make traditional IRA contributions early in the year rather than waiting until January-April of the following year. The same rationale also applies to Roth IRA contributions which are also based on MAGI.

When Must a 5498-SA be Prepared?

HSA custodians often are not certain who is to receive a Form 5498-SA. We will discuss various situations in this article concerning this issue.

Situation #1. An HSA account owner takes a total distribution of his HSA account balance in 2008, and has made no reportable 2008 contributions. Is the IRA custodian required to prepare a 5498 for this individual? The answer is, "No." No 5498-SA is required in this situation, as there are no contributions to report, and there is no fair market value as of December 31 to report.

From the 2008 Form 5498-SA Instructions: ***Total Distribution, no contributions.*** *Generally, if a total distribution was made from an HSA or Archer MSA during the year and no contributions were made for that year, you need not file Form 5498-SA nor furnish a statement to the participant to reflect that the FMV on December 31 was zero.*

Situation #2. An HSA account owner makes the maximum contribution to the HSA for 2008, and, prior to 12/31/08, takes a total distribution of the account balance. Is the HSA custodian required to prepare a 5498-SA for this individual? The answer is, "Yes." Even though the account balance is zero (0) as of 12/31/08, the contribution made in 2008 must still be reported. Therefore, a Form 5498-SA must be prepared.

Situation #3. An HSA account owner dies during 2008. His wife is his sole beneficiary. Is the HSA custodian required to prepare a 5498-SA? The rule is that upon the death of the HSA account owner, the HSA becomes the HSA of the sole spouse beneficiary. Will the HSA custodian be required to prepare one or two Forms 5498-SA? There will need to be one prepared for the decedent and one for the surviving spouse. It is assumed that the surviving spouse does not close the HSA. Even if the decedent made no contributions in the year of death, a 5498-SA must still be prepared in the name of the decedent. The surviving spouse will receive a 5498-SA as the new account owner unless he or she would take a total distribution.

From the 2008 Form 5498-SA Instructions: ***Death of Accountholder.*** *In the year an HSA, Archer MSA, or MA MSA owner dies, generally you must file a Form*

Continued on page 8

Preliminary Tax Data — IRA/Pension Statistics for 2007

IRA and SEP/SIMPLE/Keogh Deductible Contributions

33 billion dollars were contributed to traditional IRAs, SEP-IRAs, SIMPLE-IRAs and Keogh plans for 2007.

Taxpayers made contributions of $20.1 billion to SEP-IRA plans, SIMPLE-IRA plans, and Keogh plans for the 2007 tax year, compared to $20.2 billion for the 2006 tax year. The percentage of decrease was .5%. In comparison, taxpayers made contributions of $13.2 billion to traditional IRAs for the 2007 tax year, compared to $12.8 billion for the 2006 tax year. The percentage of increase was 3.3%.

The number of contributors to the SEP/SIMPLE/Keogh plans for 2007 was 1.137 million, compared to 1.177 million for 2006. The number of contributors to traditional IRAs for 2007 was 3.37 versus 3.29 million for 2007.

The average 2007 SEP/SIMPLE/Keogh contribution, per return, was $17,720.

The average 2007 IRA contribution, per return, was $3,914.

Chart A shows that there has been a substantial change (a 60% increase) in the total contribution amount to SEPs/SIMPLEs/Keoghs over the last seven years, and in the average contribution.

Chart B also shows there has been a substantial increase in the total amount of IRA contributions and the average contribution.

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	$19.4 billion	1.20 million	$16,202
2006	$20.2 billion	1.18 million	$17,200
2007	$20.1 billion	1.14 million	$17,720

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	$3,707
2006	$12.77 billion	3.29 million	$3,885
2007	$13.19 billion	3.37 million	$3,914

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	26,898	37,152	62,598	237,965	361,205	410,945	1,136,764
% of Total Returns	2.37%	3.29%	5.51%	20.93%	31.71%	36.15%	100%
Contribution Amt. **(in thousands)**	$126,525	$185,009	$493,818	$2,021,631	$5,304,201	$12,012,445	$20,143,628
% of Total Contr.	.63%	.92%	2.45%	10.04%	26.33%	59.63%	100%
Avg. Contr. Amt.	$4,704	$4,980	$7,889	$8,495	$14,685	$29,231	$17,720

CWF Observations on SEP/SIMPLE/Keogh Contributions

1. $20.1 billion is a lot of money. It is 52% more than the amount of IRA contributions of 13.19 billion.
2. The average contribution is $17,720.
3. 59% of contributions ($12.0 billion) come from individuals with AGI of $200,000 or more.
4. 86% of contributions (17.3 billion) come from individuals with AGI of more than $100,000.
5. The average contributions vary greatly depending on AGI.

What was the AGI of those who made traditional IRA contributions for 2007?

	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	160,580	475,450	737,245	1,250,702	599,641	146,515	3,370,132
% of Total Returns	4.76%	14.11%	21.88%	37.11%	17.79%	4.35%	100%
Contribution Amt. **(in thousands)**	$394,602	$1,326,757	$2,455,724	$4,957,187	$2,946,555	$1,120,030	$13,191,054
% of Total Contr.	2.99%	10.06%	18.54%	37.58%	22.34%	8.49%	100%
Avg. Contr. Amt.	$2,457	$2,790	$3,317	$3,963	$4,914	$7,646	$3,914

CWF Observations

1. The average IRA contribution, per return, was $3,914 for 2007.
2. 37% of all IRA contributions came from individuals with AGI between $50,000-$99,999.
3. 78% of all IRA contributions came from individuals with AGI between $30,000-$200,000.

The Retirement Savings Tax Credit

This credit has now been in existence for 7 years (2002 - 2008). This credit exists to induce individuals with low to moderate incomes to make IRA or 401(k) contributions.

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	288,449	2,782,750	2,602,334	296,762	0	0	5,970,293
% of Total Returns	4.83%	46.61%	43.59%	4.97%	0	0	100%
Credit Amt. **(in thousands)**	$60,558	$457,937	$428,116	$50,737	0	0	$997,343
% of Total Credits	6.07%	45.92%	42.92%	5.09%	0	0	100%
Avg. Credit Amt.	$209	$165	$165	N/A	N/A	N/A	$167

CWF Observations

1. Low- to moderate-income taxpayers were able to claim a credit of $1 billion.
2. The average credit per tax return was $167.
3. Note that 5.97 million returns claimed this saver's credit. This is more than the number of returns which showed a traditional IRA contribution (3.37 million). Contributions to a traditional IRA, Roth IRA, 401(k) plan or other elective deferral plan qualify a person for this credit.

Summary. Congress made the 2001 tax-law changes permanent with respect to IRAs and pensions in 2006. The increase in IRA contributions (from 7 billion per year to 13.19 billion per year) and the increase in SEP/SIMPLE/Keogh contributions (from 10 billion to 20.1 billion) are directly due to the 2001 law changes.

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, 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 2007 5498s relatively soon. ◆

The Pension Digest

Preliminary HSA Tax Data for 2007

The IRS has estimated that there were 581,438 taxpayers who made contributions to HSAs and who claimed tax deductions totalling 1.448 billion dollars for 2007. This means the average contribution per tax return was $2,490.

With respect to tax year 2006 the IRS had estimated that there were 351,000 taxpayers who made contributions to HSAs and who claimed tax deduction totalling 845 million dollars. The average contribution per tax return was $2,407.

Since this data comes from the 1040 tax returns it does not indicate any data for contributions made by corporate employers or deductions by corporations for having made HSA contributions.

For 2007, the maximum HSA contribution was $2,850 for self-only coverage and $5,650 for family coverage. Individuals age 55 or older were eligible to make an additional catch-up contribution of $800.

What was the AGI of those who made HSA 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	24,376	46,990	82,724	179,052	139,981	108,315	581,438
% of Total Returns	4.19%	8.08%	14.23%	30.79%	24.08%	18.63%	100%
Contribution Amt. (in thousands)	$40,832	$74,827	$124,551	$374,734	$398,611	$434,276	$1,447,829
% of Total Contr.	2.82%	5.17%	8.60%	25.88%	27.53%	30.00%	100%
Avg. Contr. Amt.	$1,675	$1,592	$1,505	$2,093	$2,848	$4,009	$2,490

CWF Observations

1. The average return showed a contribution of $2,490.
2. 87% of the contributions came from individuals with $50,000 or more of AGI. This was an increase of 7% versus 2006.
3. The largest average contribution was from the $200,000 and over group and it was $4,009 per return. The next largest average contribution was $2,848 and it came from the $100,000 to $199,999 group.

When Must a 5498-SA be Prepared?,
Continued from page 5

5498-SA and furnish a statement for the decedent. If the beneficiary is the spouse: The spouse becomes the account holder of the HSA or Archer MSA.

Situation #4. An HSA account owner dies during 2008. There is no spouse beneficiary. Is the IRA custodian required to prepare a 5498-SA? The rule is that, if there is no spouse beneficiary, or if there are non-spouse beneficiaries, the HSA ceases to be an HSA and is considered distributed and taxable to the named beneficiary as of the date of the account owner's death. Consequently, no Form 5498-SA is to be prepared for a nonspouse beneficiary, however, the final 5498-SA in the name of the decedent must still be prepared, as discussed under Situation #3.

Are January statements required for HSAs?

As all IRA custodians are aware, for IRAs, a January statement must be furnished to the accountholder by 1/31 of each year. A January statement is NOT required for HSAs. The HSA custodian may furnish a January statement as a customer service (i.e. it will be helpful for tax purposes), but it is not a requirement.

From the 2008 Form 5498-SA Instructions: ***Statements to participants.*** *If you are required to file Form 5498-SA, you must provide a statement to the participant (generally Copy B) by June 1, 2009. You may, but you are not required to provide participants with a statement of the December 31, 2008, FMV of the participant's account by February 2, 2009.* ◆