



THE Pension Digest

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Associates, Inc.,
"The Pension Specialists"



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Illustration

*Why an IRA custodian is unable to
determine the taxable amount (Box 2a)
for the 2009 Form 1099-R.*

On and after January 1, 1987, some individuals lost the right to make tax deductible traditional IRA contributions. These individuals were allowed to make nondeductible contributions. Some individuals were and are allowed to make both deductible and nondeductible traditional IRA contributions. Unlike with Roth IRAs, the individual is not allowed to withdraw his or her nondeductible contributions before the taxable earnings. With traditional IRAs, the law mandates a pro-rata approach. A portion of any distribution will be taxable and a portion will not be taxable. The individual must do this pro-rata tax calculation.

Here is an example. Jane Doe has a traditional IRA with a balance of \$20,000. She made \$10,000 of nondeductible contributions to this traditional IRA. She also has a SEP-IRA with a balance of \$12,000 and a SIMPLE-IRA with a balance of \$18,000. The total balance in her three IRAs is \$50,000. She is going to withdraw \$5,000 from her SEP-IRA. How will she report this \$5,000 on her tax return? What portion is taxable and what amount is not taxed?

She will need to calculate the portion of the \$5,000 which is not tax-

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Completion of Form 1099-R for IRA Distributions

The IRS made a major change in its instructions for completing Box 2a for traditional IRA and SEP-IRA distributions. This article discusses this change and how we understand the 2009 IRS instructions for completing boxes 1, 2a, and 2b. As will be indicated, there are situations where the IRS instructions should have been changed if the IRS wanted a consistent approach of reporting IRA distributions

This article does not address the reason codes to be used for the various distributions and does not cover non-IRA distributions. If one reviews the IRS Distribution Code Chart, the proper reason codes are generally self-evident.

Background. Leaving Box 2a blank has always been the approach used by the IRS with respect to distributions from Roth IRAs. The individual must explain on his or her tax return whether or not any taxes are owed with respect to the Roth IRA distribution.

Prior to 2009, the IRS had instructed that Box 2a was generally completed with the same amount as in Box 1 for distributions from traditional IRAs, SEP-IRAs and SIMPLE-IRAs. The IRS also strongly suggested that the IRA custodian could and should check Box 2b, "taxable amount not determined." Many recipients found Form 1099-R confusing since the amount in Box 2a indicated it was taxable, yet Box 2b said the taxable amount had not been determined.

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**Form 1099-R,
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9878 <input type="checkbox"/> VOID <input type="checkbox"/> CORRECTED		OMB No. 1545-0019		Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.	
PAYER'S name, street address, city, state, and ZIP code		1 Gross distribution \$	2009 Form 1099-R		Copy A For Internal Revenue Service Center File with Form 1096.
PAYER'S federal identification number		2a Taxable amount \$	2b Taxable amount not determined <input type="checkbox"/> Total distribution <input type="checkbox"/>		
RECIPIENT'S identification number		3 Capital gain (included in box 2a) \$	4 Federal income tax withheld \$		
RECIPIENT'S name		5 Employee contributions / Designated Roth contributions or insurance premiums \$	6 Net unrealized appreciation in employer's securities \$		
Street address (including apt. no.)		7 Distribution code(s) IRA/SEP/SIMPLE <input type="checkbox"/> Other <input type="checkbox"/>	8 Other \$		For Privacy Act and Paperwork Reduction Act Notice, see the 2009 General Instructions for Forms 1099, 1098, 3921, 3922, 5498, and W-2G.
City, state, and ZIP code		9a Your percentage of total distribution %	9b Total employee contributions \$		
1st year of design. Roth contrib. <input type="checkbox"/>		10 State tax withheld \$	11 State/Payer's state no. \$		
Account number (see instructions)		13 Local tax withheld \$	14 Name of locality \$		
		15 Local distribution \$			

Form 1099-R Cat. No. 14439G Department of the Treasury - Internal Revenue Service

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We understood the IRS' rationale for this approach to be – the IRS was well aware that an IRA custodian does not really know the taxable portion of ANY IRA distribution, be it a distribution from a traditional IRA, SEP-IRA or SIMPLE-IRA. The IRS assumed that the IRA accountholder knew that he or she was required to include the entire amount as taxable income unless he or she could support a claim that a portion of the distribution was nontaxable.

In 2009 the IRS concluded that the better approach was to leave Box 2a blank. The IRS still wants the IRA custodian to check Box 2b, the taxable amount has not been determined. However, there are some situations where the IRS does not want Box 2a to be left blank. There are times when the IRA custodian knows the taxable amount to be 0 (zero) or knows the taxable amount to be the income earned by a current year or excess contribution or the income associated with an IRA which has been revoked or closed. In such cases, the IRS wants the IRA custodian to complete Box 2a as indicated below. There are still quite a few special situations when Box 2a is not to be left blank.

The 2009 1099-R IRS instructions have two reporting categories – for "Roth IRAs" and for "IRAs Other Than Roth IRAs". The IRAs which are not Roth IRAs are traditional IRAs, SEP-IRAs and SIMPLE-IRAs. Even though the rules applying to traditional IRAs, SEP-IRAs and SIMPLE-IRAs are essentially the same, it best to have a separate discussion for each of the (4) four types of IRAs.

I. Distributions From a Traditional IRA.

Box 1 (Gross Amount)

The IRA custodian/trustee must enter the total amount of the distribution received or deemed received by the recipient. However, whenever there is any type of surrender charge or fee assessed the traditional IRA funds before the distribution is made to the individual, report only the net amount which the individual receives or is deemed to have received. For example, "in the case of a distribution by a trust representing certificates of deposit redeemed early, report the net amount distributed."

Box 2a (Taxable Amount) And Box 2b (Taxable Amount Not Determined).

Box 2a is to be left blank for distributions from a traditional IRA and a check should be placed in the checkbox for Box 2b (the "taxable amount not determined"). However, in the following situations, a check should not be placed in the checkbox for Box 2b and Box 2a should be completed as follows:

1. 0 (zero) when there has been a recharacterization out of a traditional IRA into a Roth IRA;
2. 0 (zero) when funds have been directly transferred from the traditional IRA to an accepting employer plan;
3. 0 (zero) when there has been a withdrawal of a current year contribution before the due date of the individuals' tax return, and there are either no earnings or negative earnings.
4. 0 (zero) when there has been a regular contribution followed by the IRA's closing or revocation and there are either no earnings or negative earnings;
5. xx, the earnings amount associated with the withdrawal of a current year contribution before the due date of the individual's tax return;
6. xx, the earnings amount associated when there has been a regular contribution followed by the IRA's closing or revocation.

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Continued from page 2**

7. The same amount as in Box 1 if either a rollover or transfer contribution is made followed by the IRA's closing or revocation; or
8. The same amount as in Box 1 if an amount is converted or reconverted from a traditional IRA to a Roth IRA.

Note that the IRS has the IRA custodian complete Box 2a with the same amount as in Box 1 when the IRA accountholder has done a conversion. From a tax logic viewpoint, this should not be necessary. The IRA custodian would complete Box 1 with the gross amount of the distribution and it would be up to the IRA account holder to explain the tax consequences. A conversion distribution is very similar to any other IRA distribution.

Note that the IRS also has the IRA custodian complete Box 2a with the same amount as in Box 1 when the IRA accountholder does a rollover or transfer into his or her IRA and then revoked it or it was closed for CIP reasons. Again, from a tax logic viewpoint, there is no reason to treat these distributions as being different from any other distribution. The IRA accountholder would need to explain the tax consequences on his or her tax return.

Also note that the IRS' new approach of leaving Box 2a blank also applies when an individual withdraws an excess contribution after his or her due date for that year's tax return.

II. Distributions From a SEP-IRA.

Box 1 (Gross Amount)

Enter the total amount of the distribution received or deemed received by the recipient. However, whenever there is any type of surrender charge or fee assessed the SEP-IRA funds before the distribution is made to the individual, report only the net amount which the individual receives or is deemed to have received.

Box 2a (Taxable Amount) And Box 2b (Taxable Amount Not Determined).

Box 2a is left blank for distributions from a traditional IRA and a check should be placed in the

checkbox for Box 2b (the "taxable amount not determined"). However, in the following situations a check should not be placed in the checkbox for Box 2b and Box 2a should be completed as follows:

1. 0 (zero) when funds have been directly transferred from the SEP-IRA to an accepting employer plan;
2. 0 (zero) when there has been a withdrawal of an excess contribution before the due date of the individuals' tax return, and there are either no earnings or negative earnings.
3. xx, the earnings amount associated with the withdrawal of an excess contribution before the due date of the individual's tax return;
4. the same amount as in Box 1 if either a rollover or transfer contribution is made followed by the account's closing or revocation; or
5. the same amount as in Box 1 if an employer makes a contribution to the individual's SEP-IRA and then the SEP-IRA is either revoked by the individual or closed by the SEP-IRA custodian; or
6. the same amount as in Box 1 if an amount is converted or reconverted from a SEP-IRA to a Roth IRA.

Again, note that the IRS has the SEP-IRA custodian complete Box 2a with the same amount as in Box 1 when the SEP-IRA accountholder has done a conversion, rollover or transfer.

From a tax logic viewpoint, there is no reason these distributions are treated differently than any other distribution.

III. Distributions From a SIMPLE-IRA.

The 2009 instructions contain a "What's New" section. The following is written on reporting IRA distributions. "Generally, Box 2a should be left blank when reporting distributions from traditional

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Continued from page 3

or SEP-IRAs, unless otherwise instructed later in these instructions. Box 2b, 'Taxable Amount not determined' should be checked." We read this as meaning the rules did not change for SIMPLE-IRAs. However, we will not be surprised if the IRS clarifies this at some point and uses the same rules that apply to traditional IRAs and SEP-IRAs.

Box 1 (Gross Amount)

Enter the total amount of the distribution received or deemed received by the recipient. However, whenever there is any type of surrender charge or fee assessed the SIMPLE-IRA funds before the distribution is made to the individual, report only the net amount which the individual receives or is deemed to have received.

Box 2a (Taxable Amount)

The old methodology apparently still applies to distributions from a SIMPLE-IRA. Box 2a is generally completed with the same amount as in Box 1. The checkbox in Box 2b (taxable amount not determined) is to be checked. The are exceptions when Box 2a is not filled in with the same amount as in Box 1. Box 2a is to be completed with:

1. 0 (zero) when funds have been directly transferred from the SIMPLE-IRA (after the two years) to an accepting employer plan;
2. 0 (zero) when there has been a recharacterization out of a SIMPLE-IRA into a traditional IRA to undo an attempted rollover from a traditional IRA into a SIMPLE-IRA;
3. 0 (zero) when there has been a withdrawal of an excess contribution before the due date of the individuals' tax return, and there are either no earnings or negative earnings; or
4. xx, the earnings amount associated with the withdrawal of an excess contribution before the due date of the individual's tax return.

It is unclear why the IRS chose to not apply the new reporting approach to SIMPLE-IRAs. There is no tax logic to treating distributions from a SIMPLE-IRA differently than from a SEP-IRA or a traditional IRA.

IV. Distributions From a Roth IRA.

Box 1 (Gross Amount)

Enter the total amount of the distribution received or deemed received by the recipient. However, whenever there is any type of surrender charge or fee assessed the Roth IRA funds before the distribution is made to the individual, report only the net amount which the individual receives or is deemed to have received. For example, "in the case of a distribution by a trust representing certificates of deposit redeemed early, report the net amount distributed."

Box 2a (Taxable Amount) And Box 2b (Taxable Amount Not Determined).

Box 2a is left blank for distributions from a Roth IRA and a check should be placed in the checkbox for Box 2b (the "taxable amount not determined"). However, in the following situations a check should not be placed in the checkbox for Box 2b and Box 2a should be completed as follows:

1. 0 (zero) when there has been a recharacterization out of a Roth IRA into a traditional IRA to undo either an annual contribution or a conversion from a traditional IRA;
2. 0 (zero) when there has been a recharacterization out a Roth IRA into a SEP-IRA to undo a conversion;
3. 0 (zero) when there has been a recharacterization out a Roth IRA into a SIMPLE-IRA to undo a conversion;
4. 0 (zero) when there has been a withdrawal of a current year contribution before the due date of the individuals' tax return, and there are either no earnings or negative earnings.

5. xx, the earnings amount associated with the withdrawal of a current year contribution before the due date of the individual's tax return.
6. 0 (zero) when there has been a regular Roth IRA contribution followed by the Roth IRA's closing or revocation and there are either no earnings or negative earnings;
7. xx, the earnings amount associated with a regular Roth IRA contribution followed by the Roth IRA's closing or revocation;
8. 0 (zero) when there has been a conversion or rollover from a qualified plan to a Roth IRA followed by the Roth IRA's closing or revocation and there are either no earnings or negative earnings;
9. xx, the earnings amount associated with a conversion or rollover from a qualified plan to a Roth IRA followed by the Roth IRA's closing or revocation.

Summary. The IRS made a fairly radical administrative change with respect to completing (or not completing) Box 2a (taxable amount) on the 2009 Form 1099-R. The IRS has ruled that Box 2a on the 2009 Form 1099-R is to be left blank for most distributions from traditional IRAs, SEP-IRAs and Roth IRAs except for certain special distributions. There are more special distributions than there should be. It does not appear that the procedure of leaving Box 2a blank applies to distributions from SIMPLE-IRAs. Time will tell if the IRS will issue additional guidance. ♦

Health Savings Accounts – Ability of IRS To Levy

The IRS issued additional HSA guidance on July 2, 2009, when it issued Chief Counsel Advice Memorandum number 200927019. Such memorandums are furnished to inform IRS employees of the IRS' position on a tax issue. Such memorandums may not be cited as precedent in court. But the IRS does use such memorandums in deciding what policies and procedures will be implemented.

The memorandum concludes that the IRS does have the authority to levy on Health Savings Accounts (HSA) since the right to withdraw funds from an HSA is a property right subject to IRS levy. Federal tax law (section 6331) provides that the Service may levy upon all property and rights to property of the taxpayer except property that is exempted from levy under section 6334. Section 6334 does not list HSAs as being property which is exempted from a levy against an HSA.

Since an IRS levy results in a distribution not used to pay qualified medical expenses, the taxpayer will be required to include the levy amount in his or her income and will also be subject to the 10% additional tax unless the taxpayer had attained the age of 65 or was disabled.

The law was changed so that a taxpayer does not owe the 10% additional IRA tax with respect to an IRS levy against an IRA of an IRA accountholder who has not yet attained age 59½. There is no similar express law creating an exception to the 10% premature HSA tax for an IRS levy on an HSA.

An HSA custodian may wish to adopt the following procedures if it receives an IRS levy with respect to an individual who has an HSA. Review the levy form to see if it contains a telephone number for an IRS official. Call that person and ask them if the IRS really wants to be sent the HSA funds. As with IRAs in prior years, the IRS many times only wants the HSA funds sent as a last resort because the IRS staff understands the individual will be required to include the distribution in income and also pay the 10% tax. ♦

Illustration – Surviving Spouse Age 76 May Not Want to Initially Elect to Treat Deceased Spouse's (age 64) IRA as His Own.

Set forth below is CWF's consulting response to an IRA beneficiary/situation.

The general rule is that a surviving spouse who is over the age of 59½ will normally want to treat the deceased spouse's IRA as his or her own IRA. There are exceptions. Our consulting response illustrates one of the exceptions.

You called with the following situation and question. For discussion purposes, I am going to use the names of John Doe and Mary Doe and make certain assumptions. John was born May 10, 1932, and Mary was born June 8, 1944. They were married. Mary died in 2008. She attained or would have attained age 64 in 2008. John attained age 76 in 2008. Each had named the other as his or her primary beneficiary. John has commenced taking RMD's from his IRA.

John wants to minimize his RMD's for 2010 and subsequent years.

What options does John have under the RMD rules applying to his own IRA and the IRA he has inherited from Jane?

There was the special tax law for 2009 waiving or suspending all RMD's for 2009 including from inherited IRAs. The standard RMD rules will return for 2010. He will again need to take his RMD from his IRA.

With respect to Jane's IRA, John has three options since she died before her required beginning date (the April 1st of the year following the year she would have attained age 70½).

Option #1. John can treat her IRA as his own. There is no longer an inherited IRA if he elects to treat her IRA as his own. This election can be done at any time. If he treats her IRA as his own, it will increase his RMD from his existing IRA since his balance as of December 31st would increase by the amount in her IRA. If he would make the elec-

tion sometime during 2010 (or some other future year), his RMD amount for such year would be retroactively calculated increasing his December 31 balance by the amount in the inherited IRA at the time it is treated as his own.

Option #2. John can decide to use the five year to satisfy the RMD rules for beneficiaries. He must expressly elect this option as the IRA plan agreement provides that option #3 as discussed below is his election unless he expressly elects the 5 year rule. The five year rule is simple, the inherited IRA must be closed or have a zero balance by December 31st of the year containing the fifth anniversary of Jane's death. Since Jane died in 2008, this would be December 31, 2013. There is no requirement to withdraw a minimum in any given year. The only requirement is that the account is closed by December 31, 2013. However, because of the special law waiving RMD's for 2009 (one of the five years), the IRS has provided guidance and stated that his deadline for closing the inherited IRA has changed from December 31, 2013 to December 13, 2014.

Option #3. A beneficiary is generally allowed to satisfy the RMD rules applying to beneficiaries by taking a distribution over his or her life expectancy. This is called the life distribution rule. For most beneficiaries, the first distribution must commence by December 31 of the year following the year of the death. However, there is a special rule applying to a spouse beneficiary who was the sole beneficiary. In this case, the spouse beneficiary is granted a special commencement of distributions date. John is not required to commence distributions until December 31 of the year Jane would have attained age 70½. This would be December 31, 2014 since she was born June 8, 1944.

This means John is not required to take a distribution with respect to Jane's inherited IRA until December 31, 2014. There are no RMD's required with respect to Jane's IRA for 2010-2013.

John may wish to elect to treat Jane's IRA as his own on December 31, 2014 or earlier in 2014. His combined RMD would be smaller as it would be

**Surviving Spouse,
Continued from page 6**

based on the larger joint life expectancy factor coming from the Uniform Table rather than the single life factor coming from the Single Table.

There is a risk associated with his not electing to treat her IRA as his own and he should be informed of this risk. Upon his death, the beneficiaries he has named with respect to the inherited IRA (John as beneficiary of Jane's IRA) would be required to take distributions based upon his life expectancy and not their life expectancy. For example, if he died in 2011 without having elected to treat Jane's IRA as his own, his beneficiaries would have to commence distributions by December 31, 2012, based on his age rather than their ages. He attained or would have attained age 79 in 2011. The initial life expectancy factor would be 10.8 and because the reduce by one rule applies, the factor for 2012 would 9.8, would be 8.8 for 2013, would be 7.8 for 2014, etc. In comparison, if he elected to treat her IRA as his own IRA and then named as his beneficiary an individual who attained age 55 in 2012, the factor to be used in the RMD calculation would be 29.6 rather than the 9.8. His beneficiaries with respect to the inherited IRA will be required to take out larger amounts. ♦

**Illustration,
Continued from page 1**

able and the portion which is taxable. She is required to aggregate all of her IRAs for distribution calculation purposes. The nontaxable portion of the \$5,000 would be \$1,000 calculated as follows: $\$5,000 \times \$10,000/\$50,000$ (20%) or \$1,000. The taxable portion of her \$5,000 distribution is 80% or \$4,000.

This example has been furnished to make two points. First, an IRA accountholder must aggregate all of her IRAs in order to calculate the nontaxable and taxable portions. That is, the traditional IRA, SEP-IRA and SIMPLE-IRA balances must be added. Secondly, an IRA custodian really does not know and is unable to make this calculation since it really does not know if an individual has a traditional IRA at another institution to which he or she has ever made a nondeductible traditional IRA contributions.

The IRA accountholder uses Form 8606 to determine the taxable and nontaxable portions of distributions. Adjustments to his or her basis are also reflected on the Form 8606. ♦

Marital Trust as an IRA Beneficiary, but Trust to Terminate Once Spouse Beneficiary Dies

Set forth below is CWF's consulting response to an IRA beneficiary/situation.

You called with the following situation and question. An IRA accountholder designates his or her marital trust to be the beneficiary of his or her IRA. This marital trust provides for certain sums to go to the surviving spouse and then the remainder to the children. The trust provides that after the second spouse dies, that the trust is to be terminated.

An inherited IRA is created in this situation. It would be titled, "the John Doe Trust as beneficiary of John Doe's IRA." If this trust meets the special RMD rules, annual required distributions would be required to be made over a distribution period based on the age of the oldest beneficiary. In many or most cases, this would be the surviving spouse.

For example, an IRA accountholder dies in 2009 at the age of 73. His spouse is age 64 in 2009 and is the oldest beneficiary. There is no 2009 RMD because of the special waiver law. The RMD schedule applying to the trust in following years will be determined as follows: go to the Single life table and determine the factor for a person who is 65 for 2010; this will 21.0. Future years will be determined by subtracting 1.0 each year (19.0, 18.0, 17.0, etc).

This trust is to be terminated upon the death of the spouse. Prior to the trust's termination, the trust could withdraw the then current IRA balance. This is not the only option. Under both federal and state law a trust which had an "executory" type of investment may pass-through to the trust's beneficiaries the right to receive the future payments and would not be required to liquidate the investment in order to terminate the trust. For example, assume John Doe while alive had sold a piece of real estate to a third party and the third party was to make annual payments over a 20 year time peri-

od. This right to receive annual payments was also part of this trust. If this trust would terminate, it would have the right to pass through to its beneficiaries its right to receive future payments. I believe this is also true for inherited IRA funds. It would certainly be best if the trust contained an express provision providing for the pass-through of the inherited IRA funds upon the trust's termination to an inherited IRA as established for each beneficiary of the trust. Separate inherited IRAs would need to be established for the children. The RMD schedule applying to the mother would continue to apply to the RMD distributions to be made to each child.