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

Data Processing and IRS Reporting Considerations For Roth Conversions in 2010

CWF has had more consulting calls about conversions in the last 10 days than we have had the last 10 years. Traditional IRA accounthholders are starting to convert their traditional IRAs to Roth IRAs. This article discusses converting funds from a traditional IRA to a Roth IRA; it does not discuss the converting of non-Roth funds within a 401(k) or similar plan to a Roth IRA.

A Roth IRA conversion is comprised of an actual or a deemed distribution from a traditional IRA and then the making of a conversion contribution to a Roth IRA. These two transactions may take place with the same financial institution. This is called an internal conversion. The distribution from the traditional IRA and the conversion contribution to the Roth IRA may also occur at two different financial institutions. This is an external conversion.

What traditional IRA and Roth IRA administrative forms should be completed for a Roth conversion?

A conversion contribution may either be made as a rollover (check made payable to the person), as an external transfer (check made payable to the other financial institution), or as an internal transfer (no check issued). Regardless of the approach, the traditional IRA custodian will need to prepare a Form 1099-R to report the distribution and the Roth IRA custodian will need to report the conversion contribution in box 3 of the Form 5498.

Standard IRA Distribution Form.

The traditional IRA custodian will want to furnish a standard IRA Distribution Form to the traditional IRA accountholder. This is true whether the conversion will be internal or external. The IRS "reason code" will be a "2" (Roth conversion) if the individual is under the age of 59½ and a "7" if the individual is age 59½ or older. The "2" signifies to the individual and the IRS that the individual does not owe the 10% additional tax as it is a premature distribution, exception applies. A conversion contribution is an exception to the 10% tax. The "7" signifies a normal distribution and again the 10% additional tax is not owed. The individual must furnish his or her withholding instruction; most will instruct to have no withholding.

The Roth IRA custodian will want to furnish a new Roth IRA plan agreement, if applicable, and if not, a Roth IRA contribution form. For reporting purposes, this contribution needs to be reported as a conversion contribution in box 3 on the 2010 Form 5498. From the consulting calls, we have the impression that IRA software vendors have not made it as clear as it should be what credit transaction code needs to be used to get this conversion contribution into box 3.

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Data Processing, Continued from page 1

Many software vendors still use a “rollover” description with respect to these conversions. This can be very confusing to Roth IRA personnel. It would be best for IRS reporting purposes if the software is written to use a “conversion contribution” description.

If the individual has been paid the funds, and he or she will be rolling over the funds, the Roth IRA custodian will want the individual to sign a rollover certification form to certify that he or she has satisfied the 60 day rule. The once per year rule does not apply to conversion contributions whether by rollover or transfer.

Does a separate Roth conversion IRA need to be established?

No. Prior to a law change in 1998, the IRS recommended that an individual establish a separate conversion Roth IRA for each conversion contribution. Once the law was changed the IRS no longer recommended establishing a separate conversion Roth IRA. It is certainly permissible for an individual to add a conversion contribution to an existing Roth IRA. It is the job of the individual to keep the proper records so that he or she can maintain the proper information so the Roth IRA distribution ordering rules may be applied. ◆

Completing the IRA Distribution Form

Reason for Withdrawal/Distribution (Check One)

I certify the reason for my distribution by checking the appropriate box below which best describes the reason for this withdrawal.

1. O Before Age 59 1/2 and No Known Exception or on account of a distribution to a qualifying military reservist, certain medical expenses, education expenses, payment of health insurance premiums or first time home buyer expenses. For tax reporting duties, refer to the section on this form entitled, “Read – Important Distribution Information.”
2. X Before Age 59 1/2 but an Exception Applies (check one)
   - X Conversion/Rollover to a Roth IRA (see reverse side for eligibility rules)
   - O Substantially Equal Schedule (certification to be furnished)
   - O IRS Levy
3. O Disability (certification to be furnished)
4. O Death (payment to beneficiary from beneficiary IRA)
7. X On or After Age 59 1/2 (a normal distribution)
   - X Conversion/Rollover to a Roth IRA (see reverse side for eligibility rules)
9. O Election to Revoke. I established my IRA on ________________. I now revoke. The amount of earnings distributed, if any, is ____________________________.
10. O Transfer to Other Custodian/Trustee (Name): ____________________________
    (A transfer form must be completed)
11. O Transfer to the IRA of the Accountholder's Spouse Due to Divorce/Legal Separation
12. O Transfer to the IRA of Accountholder's Spouse Due to Election to Treat as Own
13. O Transfer to Inherited IRA of Beneficiary
14. O One Lifetime Transfer/Direct Rollover to an HSA (certification to be furnished)
15. O Other Special Code: ___________ Choose from 5, 8, G, N, P, R or S as described on the reverse side. *Complete below if applicable.*
    Current-Year Contribution including an excess contribution for the current year. On ________________ I made a contribution of $________________. I now elect to withdraw the indicated portion and the allocable earnings are: $________________.
16. O Other. ____

In preparing the 2010 Form for a Conversion,

Box 3 must report conversion amount.

2828 ☐ VOID ☐ CORRECTED

TRUSTEE'S or ISSUER'S name, street address, city, state, and ZIP code

1 IRA contributions (other than amounts in boxes 2-4, 8-10, 13a, and 14a) $

2 Rollover contributions $

3 Roth IRA conversion amount $

4 Recharacterized contributions $

OMB No. 1545-0747

2010

Form 5498

IRA Contribution Information

TRUSTEE'S or ISSUER'S federal identification no.

PARTICIPANT'S social security number

5 Fair market value of account $

6 Life insurance cost included in box 1 $

Copy A For Internal Revenue Service Center

File with Form 1096.

PARTICIPANT'S name

7 IRA ☐ SEP ☐ SIMPLE ☐ Roth IRA ☐

8 SEP contributions $

9 SIMPLE contributions $

Street address (including apt. no.)

10 Roth IRA contributions $

11 Check if RMD for 2011 ☐

12a RMD date

12b RMD amount $

City, state, and ZIP code

13a Postponed contribution $

13b Year

13c Code

14a Repayments $

14b Code

Account number (see instructions)

For Privacy Act and Paperwork Reduction Act Notice, see the **2010 General Instructions for Forms 1099, 1098, 3921, 3922, 5498, and W-2G.**

Form 5498 Cat. No. 50010C Department of the Treasury - Internal Revenue Service

Do Not Cut or Separate Forms on This Page — Do Not Cut or Separate Forms on This Page

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2009 IRS Form 1099-R Special Relief

A representative of the IRS has verbally confirmed that the IRS will be making an announcement concerning the reporting changes described in the 2009 Instructions for Form 1099-R, first published in February 2009.

In general, for 2009 Form 1099-R reporting purposes, Box 1 was to be completed with the Gross distribution and Box 2a (Taxable amount) was to be left blank. Some exceptions do apply. In prior years, Box 2a was generally completed with the same amount as in Box 1. Some exceptions did apply. We discussed these changes in our February and September issues of The Pension Digest newsletter.

Apparently, there are either IRA software vendors or third party reporting vendors who did not revise their software to implement the 2009 reporting requirements or there are financial institutions which did not make the changes they needed to make even though the software had been changed by their vendor.

Special IRS Relief

The IRS will allow an IRA custodian/trustee to complete Boxes 1 and 2a of the 2009 Form 1099-R by using the IRS instructions for either 2008 or 2009. Using the 2008 instructions means it will be permissible to complete Box 2a and not leave it blank as required by the 2009 instructions. Although not yet confirmed in writing, the IRS will not impose the penalties for preparing a reporting form incorrectly if Box 2a of the 2009 Form 1099-R is not left blank when it should be left blank.

The IRS has chosen again to be nice to IRA custodians/trustees and IRA vendors. The IRS did publish the new rules in February of 2009.

It might be possible that the IRS relief is not limited to completing Boxes 1 and 2a, but that the IRA custodian/trustee would be allowed to use the 2008 instructions for completing all Boxes on the 2009 Form 1099-R.

CWF will stay on top of this matter and keep you informed of all changes. Once the IRS issues its written guidance we will issue it and all updates will be posted on our website, www.pension-specialists.com

The IRS representative did state that the 2009 reporting procedures do apply for 2010 reporting purposes and there is no special relief for 2010 reporting. The changes need to be made and implemented. ◆

Roth Conversions and Income Acceleration Rules

An individual who converts funds in 2010 will include 50% of the distribution in income in 2011 and 50% in 2012. This special rule has an averaging feature (allocating income to two tax years) and also a deferral feature since even though the distribution occurs in 2010 it is not included in income for 2010; it is first included in income in 2011 and then also in 2012.

The individual may elect to include the distribution in his or her 2010 income. He or she is not required to use the 2-year rule. This election will likely be made on the Form 8606. This election may be changed only if it is changed by the individual's due date (including extension) with respect to his or her 2010 tax return. The IRS has not yet issued the 2010 version of the Form 8606. Based on prior IRS work schedules, one can expect the 2010 Form 8606 will be issued in November of 2010.

This "2 year averaging" rule for 2010 distributions is similar to the rule which applied for 1998. These rules are not identical. In 1998, an individual included in his or her income the distribution pro-ratably over the four year period of 1998-2001. In 2010, the averaging period is 2011-2012 and not 2010-2011.

What happens if an individual makes a Roth IRA conversion in 2010 and then takes a distribution from his or her Roth IRA during 2010-2011?

In order to discourage an individual from making a conversion and then taking a distribution soon thereafter, the law has been written to include an income acceleration rule. If an individual takes a NONQUALIFIED distribution from his or her Roth IRA during 2010-2011 which is comprised of the taxable portion of a conversion, then he or she will need to include that portion in income earlier than it would have been under the 2 year pro-rata rule. The income deferred to 2012 will be accelerated first and then the income deferred to 2011 will be accelerated next.

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**Roth Conversions,
Continued from page 3**

An individual doesn't owe the 10% additional tax (Code section 72(t)) when he or she converts funds from a traditional IRA to a Roth IRA. However, if he or she withdraws such funds before the five year period commencing on the date of the conversion has elapsed, the 10% tax will be owed. There is a separate five year time period for each conversion contribution. For illustration purposes, we will assume Jane Doe has a traditional IRA with a balance of $60,000. Jane Doe is age 54. She decides to convert $30,000. She does so on January 8, 2010. Unless she elects otherwise, she will include $15,000 in her income in 2011 and the other $15,000 in her income in 2012. She has no other Roth IRAs. She has never made a regular annual Roth IRA contribution. She had no basis with respect to this $30,000; it was all "taxable".

1. If she withdraws $10,000 from her Roth IRA in August of 2010, then she will be required to include this $10,000 in her income for 2010. The acceleration rule modifies the two year rule. There were to be two pro-rata amounts for income tax purposes – $15,000 in 2011 and 2012. The $10,000 now taxable in 2010 reduces the $15,000 pro-rata amount for 2012. Thus, $15,000 will be taxable in 2011 and the remaining $5,000 will be taxable in 2012. She will owe the 10% tax with respect to the $10,000 since the distribution has occurred within the five year time period for her conversion.

2. If she withdraws $20,000 from her Roth IRA in August of 2010, then she will be required to include this $20,000 in her income for 2010, and the remaining $10,000 will be included in income in 2011.

3. If she withdraws $8,000 from her Roth IRA in September of 2011, then she will be required to include this $8,000 in her income for 2011 and also include in the 2011 the pro-rata $15,000 allocated to 2011; the remaining $7,000 will be included in her income in 2012.

What changes if the individual has made regular annual Roth IRA contributions from 1998 - 2009 before making her conversion contribution ?

The standard Roth IRA ordering rules will apply. The order of withdrawals is as follows:

1. Regular contributions;

2. Conversion contributions, on a first-in-first out basis with the taxable portion of the conversion coming out first and then the nontaxable portion; and

3. Earnings on the contributions.

The following change is made in the Jane Doe situation. In addition to her traditional IRA with a balance of $60,000, she also has a Roth IRA with a balance of $12,000. She made her first Roth IRA annual contribution on March 13, 2007 for tax year 2006. For purposes of determining if a distribution is qualified, the five year period commences on January 1, 2006.

1. If she withdraws $10,000 from her Roth IRA in August of 2010, the order rules provide that this distribution amount comes first from her annual Roth IRA contributions. Consequently, she will not include the $10,000 in income as she simply withdrew her own contributions. The acceleration rule does not apply.

2. If she withdraws $20,000 from her Roth IRA in August of 2010, the order rules provide that the return of her own contributions of $12,000 will be tax-free, but the acceleration rule will require her to include $8,000 in income for 2010. She will owe the 10% of Code section 72(t) with respect to the $8,000. She will include the pro-rata amount of $15,000 income for 2011 and she will include the remaining $7,000 in income for 2012.

3. If she withdraws $24,000 from her Roth IRA in September of 2011, the order rules provide that the return of her own contributions of $12,000 will be tax-free, but the acceleration rule will require her to include $12,000 in income for 2011. She will owe the 10% tax of Code section 72(t) with respect to the $12,000. She will include the pro-rata amount of $15,000 in income for 2011; she will include the remaining $3,000 in income for 2012.

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In summary, there is an income acceleration rule which may apply to certain individuals who make a conversion contribution in 2010 and then take a distribution in 2010-2011. The income acceleration rules will have no impact on an individual who is eligible to take qualified distributions from his or her Roth IRA. As with any tax subject, it is the responsibility of the individual and his or her tax advisor to comply with the acceleration of income rules. ◆

Rules When the Roth IRA Converter Dies.

If a Roth IRA converter has elected to use the 2 year rule in 2010 and then dies during 2010 or 2011, any amount which has not yet been included in his or her income must generally be included in his or her income for the year of his or her death. This income will need to be reported on the decedent's final income tax return.

Example # 1. If a person converts $24,000 in 2010 and then dies on October 15, 2010, his or her income for 2010 will need to include this $24,000. The right to have these funds (or any portion) included in his or her 2011 and 2012 income or that of his or her beneficiaries is lost.

Example #2. If a person converts $24,000 in 2010 and then dies on December 5, 2011, his or her income for 2011 will need to include this $24,000. The right to have these funds (or any portion) included in his or her 2012 income is lost.

Example #3. If a person converts $24,000 in 2010 and then dies on April 15, 2012, his or her income for 2012 will need to include the remaining $12,000 as there would have been $12,000 included in his or her income for 2012.

The law appears to be unsettled whether or not the decedent's executor may un-do the decedent's conversion by recharacterizing the conversion. The IRS generally adopts the position that the making of a conversion and recharacterization are personal tax rights and end when the individual dies.

Special Rules For a Spouse Beneficiary Who Is the Sole Beneficiary When the Roth IRA Converter Dies in 2010-2011

A spouse beneficiary who is the sole beneficiary can elect to continue to ratably include the amounts in income over the remaining years in the 2 year period.

Example # 1. If a person converts $24,000 in 2010 and then dies on October 15, 2010, his or her spouse beneficiary will be able to continue the 2 year schedule. He or she would include $12,000 in his or her income in 2011 and the remaining $12,000 in income for 2012.

Example #2. If a person converts $24,000 in 2010 and then dies on December 5, 2011, his or her spouse beneficiary will be able to continue the 2 year schedule. He or she would include $12,000 in his or her income in 2011 and the remaining $12,000 in income for 2012.

This income will NOT need to be reported on the decedent's final income tax return as it will be reported on the surviving spouse's tax return. ◆

Social Security Number Truncation

On December 21, 2009, the IRS issued Notice 2009-93, as published in Internal Revenue Bulletin 2009-51, concerning the truncation of Social Security Numbers and certain other identifying numbers for reporting years 2009 and 2010.

Because of the growing concerns over the security of personal data, including Social Security Numbers, the IRS has initiated a "Pilot Program" allowing the truncation or masking of certain identifying numbers on certain reports for 2009 and 2010.

A "Pilot Program" means it is not permanent and it is not a mandatory procedure. It is, however, effective immediately.

"Truncation" means the identifying numbers are hidden or concealed in a certain way so as not to reveal the entire number.

"Identifying Number" in this Notice only refers to a Social Security Number, an IRS Individual Taxpayer

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Truncation,
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Identification Number, or an IRS Adoption Taxpayer Identification Number.

This Pilot Program only applies to IRS Forms 1098, 1099, and 5498. It only applies to the paper copies for the payee, for instance, paper copies to the IRA accountholder or to the QRP participant. It does not apply to any filings with the IRS. It also applies to any valid substitute or composite substitute form's paper copy sent to the payee. Electronic copies sent to the payee are not included.

This IRS Notice will consider the applicable filer to be in compliance with all requirements in Treasury and IRS guidance, whether in a regulation, form, or form instructions, to include a payee's identifying number on a payee statement. The applicable filer must also comply with all other reporting rules, regulations, and procedures.

Compliance of this Pilot Program must include the following:

- The only Identifying Numbers that can be truncated are the Social Security Number, IRS Individual Taxpayer Identification Number, or IRS Adoption Taxpayer Identification Number,

- The Identifying Number is only truncated with asterisks or Xs in a specific manner. The first five numbers of the Identifying Number are replaced with asterisks (*) or Xs.
  EXAMPLE SSN 123-45-6789 is truncated to ***-**-6789 or XXX-XX-6789,

- Truncation of the Identifying Number can only be used on the payee paper forms of Forms 1098, 1099, and 5498 and only for calendar years 2009 and 2010.

Because it is a pilot program, the IRS is asking for comments by May 1, 2010. In particular, the IRS would like comments on the following:

- Should truncation of an individual's identifying number be required, rather than just permitted?
- Should truncation of an individual's identifying number be permitted or required on paper copies of statements beyond the scope of this Pilot Program?
- Should truncation of an individual's identifying number be permitted or required on payee statements furnished electronically?
- Does truncation create difficulties for filers and/or payees?
- Any other comments relating to this procedure are also encouraged by the IRS

Comments should be submitted (mailed) to:

Internal Revenue Service
CC:PA:LPD:PR(Notice 2009-93), Room 5203
P.O. Box 7604, Ben Franklin Station, N.W.
Washington, D.C. 20044

Comments can be hand delivered, Monday through Friday, between 8:00 a.m. and 4:00 p.m. (Eastern Time Zone) to:

CC:PA:LPD:PR(Notice 2009-93), Courier's Desk
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington D.C.

Comments can also be submitted electronically via the following e-mail address:

Notice.Comments@irscounsel.treas.gov
(Include "Notice 2009-93" in the the subject.

The IRS advises that all comments will be available for public inspection.

A link to the complete IRS Notice is available on the CWF website. ◆

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Pension and IRA Proposals by the Obama Administration

On September 5, 2009 the Obama administration issued the proposals set forth below. These proposals would expand the automatic enrollment approach to IRAs in addition to 401(k) plans. Although workplace IRAs would be "voluntary" for employees it does not appear they would be "voluntary" for the employer.

Retirement Security for American Families

"If you work hard your whole life, you ought to have every opportunity to retire with dignity and financial security. And as a nation we ought to do all we can to ensure that folks have sensible, affordable options to save for retirement." – President Barack Obama

As many as 78 million working Americans-about half the workforce don't have a retirement savings plan at work. Fewer than 10 percent of those without plans at work contribute to a plan of their own. Our nation needs to do more to help families save and give them better choices to reach a secure retirement.

Today, President Barack Obama and Secretary Tim Geithner announced new steps to make it easier for American families to save for retirement. These new initiatives will complement the president's major legislative proposals to boost participation in IRAs and match retirement savings. The Department of the Treasury will:

- Expand opportunities for automatic enrollment in 401(k) and other retirement savings plans,
- Make it easier for more than 100 million families to save a portion or all of their tax refunds,
- Enable workers to convert their unused vacation or other similar leave into additional retirement savings, and
- Help workers and their employers better understand the available options for tax-favored retirement saving through clear, easy-to-understand language.

Together, these steps will expand the range of choices for workers who want to save and will make saving easier for millions of Americans.

NEW INITIATIVES TO HELP FAMILIES SAVE

(1) Expand Automatic Enrollment in 401(k) and Other Retirement Savings Plans: Under automatic 401(k) plans, employers directly deposit a small percentage of each paycheck into workers' retirement accounts. Employees maintain full choice over whether and how much they want to save. Each employee can choose to opt out of the plan or save a different amount, and employers can easily match employee contributions. Automatic enrollment boosts participation in 401(k) retirement plans from about 70 percent to more than 90 percent, and it is particularly effective in increasing the participation of low-income and minority workers. But while nearly half of larger companies with 401(k) plans have adopted automatic enrollment, fewer medium-sized or small businesses have done so. The Administration will

- Streamline the process for 401(k) plans to adopt automatic enrollment. Plan sponsors typically seek Internal Revenue Service approval of plan amendments to ensure legal compliance. By issuing pre-approved automatic enrollment language, the IRS will allow plan sponsors to amend their plans to adopt automatic enrollment more quickly, without the need for case-by-case approval by the IRS.

- Make it easier to increase saving over time. A promising approach to boosting retirement savings is to manually increase automatic worker contributions over time. For example, – workers could dedicate a portion of their pay raises to retirement savings or be put on a path to save a higher percentage of their pay every year, while remaining free to stop the increases or opt out entirely at any time. Treasury and the IRS are releasing a ruling explaining how 401(k) plans can use this automatic increase feature.

- Allow automatic enrollment in SIMPLE-IRAs. The SIMPLE-IRA combines the basic elements of 401(k) plans and IRAs, creating an easily administrable retirement plan that small businesses can offer to their employees. An estimated 3 to 4 million SIMPLE-IRA accounts exist, but workers are not automatical-

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Proposals
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ly enrolled. Treasury and IRS are now issuing guidance to help interested employers automatically enroll employees in SIMPLE-IRA plans so long as employees are free to opt out.

(2) Create Easier Ways to Save Tax Refunds: More than 100 million families receive federal income tax refunds each year. Averaging more than $2,000, tax refunds present a unique opportunity for families to save. Tax payers can already instruct the IRS to directly deposit their refunds and dedicate a portion to an IRA or other savings vehicle. Today, the Treasury and IRS announced that taxpayers will have another savings option beginning in early 2010 – the ability to use their refunds to purchase US. savings bonds simply by checking a box on their tax return, without having to open an account at Treasury or take any other action, and even if the taxpayer doesn't have a bank account. The savings bonds would be mailed to the taxpayer. Taxpayers will be able to purchase bonds in their own names beginning in 2010 and to add co-owners such as children or grandchildren beginning in 2011.

(3) Allow Unused Leave to Be Converted to 401(k) Savings: Every year, millions of workers leave their jobs and receive substantial payments, often in cash, for unused vacation or other similar leave. For many employees, this money could easily be saved. Treasury and the IRS are issuing two rulings today describing how employers can allow their employees to contribute those amounts to their 401(k) plan. As an alternative, the rulings also give employers the option of making their own contribution of these amounts to their employees' 401(k) or other plan.

(4) Explain Saving Options: Employees changing jobs and receiving paycuts from a retirement plan face a number of choices, including a tax-free "rollover" of their benefits to – another retirement account. These choices are not always well understood. Today, Treasury and the IRS are issuing a plain-English road map for rollovers to help workers keep their savings in tax-favored retirement plans or IRAs until they are ready to retire, rather than withdrawing cash earlier, subject to tax penalties. The road map is an updated model notice for plans to give departing employees. It clearly explains how to roll over plan balances, the key decisions, and the tax consequences. In addition, the IRS has created new user-friendly web site materials to help employers select an appropriate retirement plan and to help employees better understand the benefits of saving for retirement.

To read the Treasury and IRS rulings and materials, please visit http://www.irs.gov/retirement.

BUILDING ON EXISTING OBAMA Retirement PROPOSALS

The Obama Administration is committed to giving tens of millions more Americans more and better choices to save for retirement through their jobs and receive tax benefits for doing so. The president will continue to work to expand and strengthen employment-based retirement security. Today's steps complement two important initiatives included in President Obama's budget:

- **Create Automatic IRAs:** IRAs are intended to give a tax-favored saving opportunity to the millions of workers – about half the American work force – who have no workplace retirement plan. Yet fewer than 1 out of 10 workers who are eligible to make tax-favored contributions to an IRA actually contribute to an IRA, while 9 out of 10 workers automatically enrolled in a 401(k) plan continue to make contributions. When enacted by Congress, the Administration's proposal will automatically enroll workers without workplace retirement plans in IRAs through payroll deposit contributions at the workplace. The contributions will be voluntary – employees will he free to opt out – and matched by the Savers Tax Credit for eligible families. *(Underlining added by CWF)*

- **Reform and Expand the Savers Credit to Match Retirement Savings:** The expanded Savers Tax Credit will match the retirement savings of millions of families. It will match half of families' savings up to $500 per individual each year and deposit the tax credits directly into the individual's 401(k) plan account or IRA. The credit will be available to low- and middle-income working families, including those who earn too little to owe income taxes. ◆