THE Pension Digest

July, 2013
Published Since 1984

ALSO IN THIS ISSUE –

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

QCD Season and RMD Season

Soon it will be August and soon it will be the RMD season. That is, it is the time many of your 70½ and older IRA accountholders are paid their RMD for 2013. Many times the RMD is moved by a pre-authorized transfer from their IRA to a savings or checking account. Or, a check is mailed.

Some of your 70½ IRA accountholders (and also inheriting beneficiaries) may want to make a QCD if they only knew and understood the applicable tax laws.

QCDs are authorized for 2013 as long as made by December 31, 2013. QCDs will apply to 2014 only if there is tax legislation enacted extending such rules to 2014/2015 and possibly subsequent years. Another extension of this law is not a sure thing. If the idea is to collect more tax revenues one does not want to extend the QCD rules.

Your local charities and other nonprofits benefit when qualifying individuals make QCDs. The individual benefits also. A QCD is a tax-free distribution and it also counts as an RMD. Qualifying IRA accountholders are those age 70½ and older, including inheriting IRA beneficiaries age 70½ and older.

Your institution can benefit also. Earn some goodwill by informing your qualifying IRA accountholders that your institution is willing to help them make their QCDs.

Continued on page 2

Moving Nondeductible Funds from a 401(k) into a Roth IRA

This article discusses moving basis within a 401(k) plan or a profit sharing plan into a Roth IRA.

A customer wanting to make a direct rollover or rollover contribution of pension funds containing basis should always be advised to consult with his or her tax advisor as this is complicated tax subject. One reason is – the IRS has not been willing to give definitive written guidance.

Discussion of a hypothetical situation is helpful. Let's assume Jane Doe has a 401(k) balance of $50,000, it is comprised of two portions – $40,000 (deductible/taxable contributions and earnings) is taxable and $10,000 is nontaxable (i.e. basis).

Is it possible for Jane to directly rollover the $40,000 of taxable money in the 401(k) plan to a traditional IRA and then directly rollover (i.e. convert) the $10,000 of basis into a Roth IRA?

No. When there is a direct rollover or direct rollovers the pro-rata taxation rule will not allow only the basis to go into the Roth IRA. That is, if $10,000 goes into the Roth IRA, $8,000 of it will be taxable and $2,000 will be nontaxable under a direct rollover approach. Jane will include the $8,000 in her income and pay tax on it. This means she will still have $8,000 of basis with the traditional IRA.

Continued on page 3

IRAs and Bankruptcy and a Strict Reading of the Prohibited Transaction Rules.

In the June newsletter it was discussed that there is now a split in the U.S. circuit court of appeals whether an inherited IRA is to be exempt from the bankruptcy trustee and the individual's creditors. The majority approach is that an individual who has an inherited/beneficiary IRA is able to exempt such funds from the bankruptcy trustee.

In the May newsletter we discussed that the DOL has proposed a class exemption to resolve prohibited transaction problems arising from the fact that many firms of the securities industry, in general have written their investment account agreements to contain a cross-collateralization provision allowing the securities firm to take money from any account (including IRAs) if any of the individual's non-IRA investment would incur a negative balance. It certainly appears a prohibited transaction occurs when an individual grants a broad lien on his or her IRA. When a prohibited transaction occurs, the tax result is the IRA is deemed distributed as of the first day of the year. Since the funds are on longer IRA funds, the bankruptcy trustee may reach such funds. The grant of the PT exemption by the DOL will mean the IRAs are not taxable. This assumes the securities firms correct their IRA forms by the DOL's deadline.

On June 17, 2013, the Sixth Circuit decided a bankruptcy case (In re James L. Daley, Jr.) involving a person's traditional IRA set up with a securities firm. An IRA and/or inherited IRA qualifies as exempt property in bankruptcy only if the IRA is tax exempt under Code section 408 (traditional) or 408A (Roth). If a prohibited transaction had occurred, then the IRA is no longer exempt under Code section 408/408A.

The bankruptcy filer had opened an IRA (rollover of $66,000) with Merrill Lynch. He signed a client relationship agreement containing the following provision –

> All of your securities and other property in any account - margin or cash - in which you have an interest, or which at any time are in your possession or under your control, shall be subject to a lien for discharge of any and all indebtedness or any other obligations you may have to Merrill Lynch.

On account of his granting this lien on his IRA, the bankruptcy court and the district court had ruled that a prohibited transaction as defined in Code section 4975 had occurred. The IRA was deemed distributed and thus the bankruptcy trustee could claim the $66,000.

The 6th Circuit Appellate court reversed with the following "technical" reasoning. The individual had no other accounts with Merrill Lynch and he had no other debts with Merrill Lynch. Since there was no other account(s) or debts, there was no impermissible loan made and there was no prohibited transaction. If the individual had had another account with Merrill Lynch, which could have incurred a negative balance the result would have been very different.

QCDs,
Continued from page 1

CWF has a brochure explaining the QCD rules and benefits and also an administrative form which acts much like a transfer form. Remember that one of the critical rules is that the check must name the charity as the payee. There is no requirement by an IRA custodian to use the QCD administrative form. One uses the form for good administrative practices. The administrative form may be sent to the charity. Your institution may decide whether or not you would require the charity to sign it. The charity's signature is not required.

To order brochures or forms go to:
www.pension-specialists.com/orderforms/QCD order form.pdf

Can SEP Contributions be Deposited into a Traditional IRA?

The answer is "yes" if your IRA plan agreement is based on the IRS model forms 5305 and 5305-A and if the SEP plan agreement is based on the IRS model form 5305-SEP. The answer would be "no" if the IRA plan agreement was written to only allow annual IRA contributions or only allow employer SEP contributions.

The IRS has written Forms 5305 and 5305-A to allow annual contributions up to $5500/$6500 limits, SEP contributions, rollover contributions and recharacterization contributions. There needs to be a special provision authorizing transfer contributions. The CWF plan agreements have such a provision.

Some financial institutions have adopted the administrative practice that SEP contributions must be made to an IRA which has no other type of contribution (i.e. annual IRA or rollover). Technically, if the IRA plan agreement has not been amended to contain this limitation, then the individual could make both types of contributions.

Set forth below is the IRA guidance on this subject/question.

Can SEP Contributions be Deposited into a Traditional IRA?

Can my employer deposit the SEP contribution from my work plan into my existing traditional IRA or must I set up a separate SEP-IRA?

Your employer may be able to deposit SEP contributions into your traditional IRA depending on the:

- requirements that apply to your traditional IRA, and
- terms of your employer's SEP plan document.

Terms of the Traditional IRA

The financial institution where you have your IRA may restrict the type of contributions that can be made to your IRA. Ask your financial institution if it will accept your employer's SEP contributions for deposit into your existing traditional IRA.

SEP plan document

Your SEP plan document may require your employer to deposit SEP contributions into a SEP-IRA at a specific financial institution. Review your SEP plan document to see where your SEP contributions can be deposited.

Nondeductible Funds,
Continued from page 1

This is not the result she wants. She wants to have no basis within the traditional IRA and she wants only basis to go into the Roth IRA so she will not have to pay any income tax.

Is there an approach which allows Jane to pay no tax with respect to the $10,000 she puts into her Roth IRA?

Yes, but she will need to have access to some additional funds ($8,000) as explained below.

Jane will need to instruct the 401(k) administrator that she wishes to have her plan balance of $50,000 paid to her in cash. She cannot do a direct rollover and achieve the desired result. Since she is paid cash, the plan administrator will withhold 20% of the <u>taxable</u> amount of the distribution. The plan will give her a check for $42,000. 20% must be withheld from the $40,000 or $8,000. 0% must be withheld with respect to the basis (i.e. her own nondeductible contributions). Thus, she is paid $42,000 ($32,000 + $10,000).

Jane now has 60 days to rollover this $42,000 distribution. She may do so by making multiple rollover contributions. First, she wants to rollover the $40,000 into her traditional IRA. Later, she wants to rollover the $10,000 into her Roth IRA. Since she only has $2,000 as the other $8,000 was withheld, she will need to add her own $8,000 to make the $10,000 rollover. This $8,000 can come from other personal funds or possibly from a loan.

Why must she do it this way? Code section 402(c)(2) provides that when a person has basis within the 401(k) plan and takes a distribution, that the taxable amount comes out first and the nontaxable amount comes out second. Because of this rule, she may make a roll over contribution of $40,000 to her traditional IRA and then a rollover contribution of $10,000 to her Roth IRA. The $10,000 she contributes to her Roth IRA will be her basis or the nontaxable amount. In this situation, the pro-rata rule is not used. Although asked numerous times, the IRS has not confirmed that this approach works so that all of the $10,000 going into the Roth IRA is basis and nontaxable.

2011 Rollover Contributions

IRAs hold more than 25% of all retirement assets in the United States. Much of those assets arise from rollover contributions coming from the distributions of participants of employer sponsored pension plans rather than annual IRA contributions.

The 2011 total contribution amount due to rollovers was $76,566,000,000 whereas it was $5,962,000,000 for annual contributions. That is, the amount contributed as rollover contributions was 13 times the size of the annual contributions. These amounts and ratios are consistent with such amounts and ratios derived from IRS data.

This rollover article is based on an article written by Craig Copeland with the recommended citation, Craig Copeland, "Individual Retirement Account Balances Contributions, and Rollovers, 2011." This article is copyrighted, but it may be used without permission as long as there is a citation of the source.

The number of IRAs within the EBRI data base receiving rollover contributions was 1,058,000 whereas it was 1,601,000 million for annual contributions. The average annual contribution was $3,723. The average rollover contribution was $72,398. There is a reason that most financial institutions direct their marketing campaigns towards rollover contributions and direct transfers in the case of inherited IRAs.

IRA Rollovers in 2011 (1,058,000)

	Number (in thousands)	Percent	Average	Total Dollars (in millions)
Under age 25	16	1.5	$9,079	$ 147
25-29	69	6.5	$11,122	$ 768
30-34	89	8.4	$20,810	$1,847
35-39	91	8.6	$34,157	$3,107
40-44	102	9.7	$45,998	$4,708
45-49	108	10.2	$56,284	$6,075
50-54	116	11.0	$70,596	$8,223
55-59	115	10.8	$94,194	$10,802
60-64	133	12.6	$121,106	$16,107
65-69	88	8.3	$123,265	$10,835
70 or older	62	5.9	$109,516	$6,793
Unknown	68	6.4	$104,891	$7,152
Total	1058	100.0%	$72,398	$76,566
Gender				
Female	347	32.8%	$56,671	$19,687
Male	476	45.0%	$88,973	$42,376
Unknown	235	22.2%	$62,005	$14,503
Total	1058	100.0%		

The Pension Digest

IRA Rollovers by Females in 2011 (347,400)

	Number (in thousands)	Percent	Average	Total Dollars (in millions)
Under age 25	5.3	1.5	$8,575	$45
25-29	24.3	7.0	$9,606	$ 234
30-34	30.2	8.7	$18,717	$ 547
35-39	29.1	8.4	$29,280	$ 852
40-44	32.4	9.3	$38,614	$1,251
45-49	35.5	10.2	$46,404	$1,645
50-54	39.5	11.4	$56,499	$2,230
55-59	38.7	11.1	$72,467	$2,805
60-64	42.8	12.3	$87,295	$3,738
65-69	28.0	8.0	$90,367	$2,527
70 or older	18.9	5.4	$84,904	$1,604
Unknown	22.8	6.6	$96,959	$2,208
Total	347.4	100.0%	$56,671	$19,687

IRA Rollovers by Males in 2011 (476,300)

	Number (in thousands)	Percent	Average	Total Dollars (in millions)
Under age 25	6.5	1.4	$10,632	$70
25-29	27.1	5.7	$12,979	$ 351
30-34	35.8	7.5	$24,083	$ 862
35-39	38.1	8.0	$39,087	$1,490
40-44	45.8	9.6	$52,841	$2,419
45-49	48.4	10.2	$65,900	$3,193
50-54	52.4	11.0	$83,872	$4,398
55-59	51.7	10.9	$115,408	$5,969
60-64	62.4	13.1	$148,434	$9,258
65-69	41.2	8.7	$149,160	$6,149
70 or older	29.0	6.1	$129,898	$3,772
Unknown	37.7	7.9	$117,839	$4,446
Total	476.3	100.0	$88,973	$42,376

Contributions and Rollovers by Size

Contributions	No. in Thousands	Percent
All	1,601	100.0%
Less than $1,000	273	17.0
$1,000–$1,999	196	12.3
$2,000–$3,999	242	15.1
$4,000–$4,999	83	5.2
$5,000–$6,000	807	50.4
Rollovers		
All	1,058	100.0
Less than $2,000 1	171	6.2
$2,000–$4,999	151	14.2
$5,000–$9,999	93	8.8
$10,000–$24,999	160	15.2
$25,000–$49,999	141	13.4
$50,000–$74,999	82	7.7
$75,000–$99,999	53	5.0
$100,000–$149,999	69	6.5
$150,000–$249,999	65	6.2
$250,000 or more	72	6.8

Observations

1. The average rollover amount was $72,398.
2. The average rollover for males was $88,973.
3. The average rollover for females was $56,671.
4. 30.4% of the rollovers were less than $5,000.
5. 54.4% of the rollovers were less than $25,000.
6. 19.5% of the rollovers were $100,000 or more and such rollovers accounted for 75.7% of the assets rolled over. That is, 58 billion of the 76.6 billion rolled over was done so by those 206,000 individuals with rollover amounts of $100,000 or more. Their average rollover was $281,500.

Average IRA Balance by Account by Gender

Males	$90,563
Females	$54,159

Average IRA Balance by Gender and Age

	Female	Male	Percentage
Under age 25	$12,813	$14,014	91.4%
25-29	$11,715	$14,591	80.2%
30-34	$16,944	$21,504	78.8%
35-39	$25,321	$33,098	76.5%
40-44	$33,828	$46,896	72.1%
45-49	$44,213	$63,296	69.9%
50-54	$56,537	$84,935	66.6%
55-59	$70,176	$112,673	62.3%
60-64	$87,597	$153,887	56.9%
65-69	$102,224	$195,680	52.2%
70 or older	$103,224	$203,066	50.8%
Unknown	$244,380	$313,867	N/A
Average	$54,159	$90,563	59.8%

Observations

1. The average IRA balance increases for each 5-year period as individuals age. The average balance for males grows substantially more than for females. At ages 70 and above the average female balance is $103,224 whereas it is $203,066 for males. On a percentage basis this is 59.8%. This percentage basis decreases over every 5-year period.
2. The average balance for males over age 55 is $100,00 whereas this amount is not realized by females until ages 65-69 and older.

The Pension Digest

Email Consulting Guidance

Q-1 Nondeductible IRA Contributions

I have a client John, who made $6,000 IRA contributions in 2012 to both his and his wife's accounts. John's DOB is 8/13/1949, Lana's DOB is 9/10/1952.

In doing his taxes he realized he shouldn't have done the one for his wife since she maxed out her 401(k) contribution for 2012 in anticipation of her retirement this year. He said he could only get credit for the $6,000 he contributed to his IRA (He does his own taxes).

Since he couldn't claim her $6,000 contribution he says he has paid the taxes on her amount. He wants to know what he has to do to assure she won't get taxed on that amount when she withdraws the funds later on. Should she remove those funds as an excess?

A-1 She will need/want to withdraw the $6,000 plus the related income. If they filed their tax return by April 15, 2013, she has until October 15, 2013 to take the withdrawal.

A pro-rata taxation rule applies when a person takes a distribution from their traditional IRA when one or more of their IRAs has basis. That is, a person has made a nondeductible contribution. The tax rules do not allow the person to take out the nontaxable amount first and then the taxable amount. For example, Jane Doe has $24,000 in her traditional IRA and she makes a $6,000 nondeductible contribution. The $24,000 would have been fully taxable had she taken a distribution as she had never made a prior nondeductible contribution. Assume she withdraws $1,000 from the $30,000.

$200 of the $1,000 will be nontaxable since $6,000/$30,000 x $1,000 = $200. The $6,000 is her basis. $800 of the $1,000 will be taxable since $24,000/$30,000 x $1,000 = $800. The $24,000 is the amount in her IRAs which is taxable when withdrawn.

Her basis would then be reduced to $5,800. And the same formula would be used for subsequent distributions, but the revised basis of $5,800 would be used. This calculation is done by the taxpayer on Form 8606. It can take many partial distributions and many years for an individual to withdraw this basis.

There is another tax rule which complicates the situation. The rule – a person who makes a contribution in 2012, but withdraws it in 2013 by the deadline, is to include the income on the 2012 tax return as the income is taxable for the year the contribution is made and not for the year in which it is withdrawn. Technically, the individual is to file an amended tax return, but it may be the interest earned is sufficiently small some taxpayers might decide from a practical standpoint to not file the amended return. The individual might include the income on the 2013 return rather than the 2012 return even though this is not correct. A 2013 Form 1099-R is prepared by the bank even though it impacts the 2012 return.

Q-2 The New 3.8% Tax and IRA Distributions

In the April 2013 Digest, I was reading the article regarding the new 3.8% tax that went into effect in January. You said a person who takes an IRA distribution may have to pay this tax because it could cause them to go over their MAGI. The example said his payment was $380 because the $10,000 IRA distribution took him over. I did understand what was said. But what I am confused about is in another paragraph you stated that Distributions from IRAs are considered non-investment income. Why did he have to pay? Is there a difference I am not understanding?

A-2

A tax of 3.8% is assessed the lesser of : (1) a person's net investment income or (2) the person's MAGI above a certain threshold.

The statement was made that a person must have some net investment income. And the statement was made that an IRA distribution is not net investment income. Both statements are correct.

In the example where there was tax owing of $380, the individual had wage income of $160,000, dividend income (which is net investment income) of $40,000 and an IRA distribution of $10,000. He owes the 3.8% tax on $10,000 since his MAGI of $210,00 exceeded the threshold amount of $200,000 by $10,000. If he

Continued on page 8

had not had the $10,000 IRA distribution there would have been no 3.8% tax since his MAGI would have been $200,000.

Note that if the person would have had wage income of $160,000 and an IRA distribution of $50,000, then there would have been no 3.8% tax as 3.8% times the lesser of 0 (net investment income) or $10,000 ($210,000 - $200,000) is 0.

Also note that the second limit is not limited to (i.e. has nothing to do with) net investment income. It is based on a person's MAGI and filing status. This means some IRA distributions (not all) will result in a person having to pay the 3.8% tax. Obviously, the intent of the law is not to make things simple. Rather, the law is written to collect more taxes in certain situations from individuals with higher incomes.

In the first paragraph of the article an explanation is made that the IRS calls this new tax the investment income tax. The IRS is being misleading. In some situations this tax has little to do with net investment income. The statute uses the term, Unearned Income Medicare Contribution.

Q-3 HSA Fees

I have been doing some studying of HSAs and was trained that we were not allowed to charge fees to our HSA customers. In my findings, online and otherwise, I have been able to find where there are banks that charge fees to their HSA customers. Where would I have been mixed up in my thought process? What is your guidance on this? We have approximately 300 HSAs in our clientele and I feel like we've missed the boat on fees.

A-3

To the best of my knowledge, CWF has never indicated that fees could not be charged to or on account of an HSA.

Fees properly disclosed may be charged.

We would have said, a bank should never charge a fee if that fee will put the HSA into a negative balance. It is possible to charge a fee as long as the HSA maintains a positive balance and there has been proper disclosure of the fee(s).

In general, the bank could start charging fee(s) 30 days after furnishing an amending disclosure.

Q-4 5498 Forms Required for Inherited IRAs

An associate had called from our office to you on Friday and asked about 5498s. She left me a note that said you said we should see a 5498 for the referred to Inherited Transfer Account.

I have always been under the understanding that transfers are non reportable, thus no 5498 is generated. I have a sheet from a training manual from a meeting of your's years ago that states that.

What am I missing here?

I feel the account should have a FMV statement but not a 5498.

A-4

A transfer is non-reportable as there is no box on the 5498 form to report a transfer. However, there is still box 5 asking for the fair market value as of 12-31. The reporting rule is, report in box 5 (this means a 5498 form needs to be prepared) the fair market value as of 12-31. There is no exception to the rule saying box 5 need not be completed for an inherited IRA This is true even if the FMV is the same as the transfer amount.

The IRS needs to be furnished a Form 5498 (or electronically) with box 5 completed. You are correct, the beneficiary must be furnished a FMV statement, and as long as that FMV statement has the necessary language the IRA custodian is not required to furnish a 5498 to the individual in May as he/she has already been given the FMV.

Be aware there is no duty to prepare the Form 5498 for a Inherited IRA which was transferred-in, if subsequently, the beneficiary withdraws the entire balance so there is no balance as of December 31.