



THE Pension Digest

ALSO IN THIS ISSUE –

Transfers—We May All Long for the Good Old Days, but New Rules Must be Acknowledged,
Page 4

FMV for In-Kind Distributions,
Page 7

Questions About Roth IRAs,
Page 8

CHARGING FEES FOR RECHAR- ACTERIZATIONS

Some IRA custodians and trustees, because of the labor intensiveness and the substantial paperwork required, are starting to wonder if they should charge a fee to perform a recharacterization. Some IRA custodians/trustees may even be thinking—if we set our fee sufficiently high, then no one will do a recharacterization and then we don't have to deal with them.

This is a “be careful” and “wait for additional guidance from the IRS” situation. Why?

You may ask, “Many IRA custodians have transfer fees, and wouldn't recharacterization fees be very similar?”

Our answer is “no.” A recharacterization is fundamentally different from a transfer. Whether or not an IRA accountholder has the right to transfer his or her IRA funds is a contractual right. Therefore it is clearly permissible to charge fees to assist with a transfer. In contrast, the Internal Revenue Code (i.e. the law) creates the legal right for each IRA accountholder to recharacterize his or her contribution(s).

As you know, recharacterizations are relatively new. The IRS has not had much time to develop policies and procedures except as set forth in Regulation 1.408A. I don't believe the IRS has yet been presented with or discussed to any extent whether

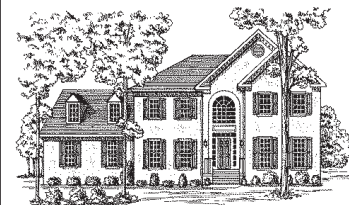
or not it is permissible to charge a fee for a recharacterization.

We don't believe the IRS will allow an IRA custodian/trustee to write an IRA plan agreement to take away from an IRA accountholder the right to have a recharacterization or to impose an unreasonably high fee. In fact, if forced to rule on this issue, the IRS might rule that any fee for a recharacterization would be impermissible.

Until the IRS says more on this subject, the most conservation approach would be to not charge fees for recharacterizations. But this is probably more conservative than an IRA custodian or trustee needs to be. The IRS most likely would find a reasonable fee acceptable.

The legal approach to fees as adopted by the majority of IRA custodians/trustees appears to be—any fee is permissible as long as the accountholder has agreed to such fee (either at establishment or by consenting to a proposed amended fee schedule) and as long as the fee is reasonable. The reasonable requirement arises from the belief that there may be some fiduciary limits to fees. That is, they must be reasonable or there may be a violation of a fiduciary duty owed to the accountholder.

You will want to continue to monitor this issue.



FIRST-TIME HOME BUYER, CODE 1 OR CODE 2?

It is the time of year when tax preparers and IRA accountholders are asking IRA personnel to correct the Form 1099-R they received in January because they believe you should have used a “2” rather than a “1” in box 7 of the Form 1099-R.

Most often such a correction need not be made by the IRA custodian/trustee because the IRA accountholder and the tax preparer have an incorrect understanding of the purposes of the Form 1099-R and the related Form 5329. Too many times they do not understand how and when the Form 5329 is completed to claim exemption from the 10% additional tax. One factor that leads to many misunderstandings is that the Form 1099-R and the Form 5329 are NOT just used to report distributions from IRAs; they are also used to report distributions from pension plans and annuities other than IRAs. This

Continued on page 2

**First-Time Home Buyer,
Continued from page 1**

article is devoted to discussing the IRA issues.

The Form 1099-R

The Form 1099-R is the form used by an IRA custodian to inform the IRS and the account holder that there has been a reportable distribution from an IRA. Because of the nature of IRA law (traditional, Roth and Education), the IRA custodian does not tell the IRS in most situations to what degree this distribution is taxable. The reason is that the IRA custodian does not have sufficient information. The account holder (or his or her tax preparer) will need to indicate the proper tax effect of this distribution.

The IRA custodian or trustee generally faces this same lack of knowledge when it comes to determining if the IRA account holder qualifies for one of the many exceptions of Code section 72 so that the 10% (or 25% in the case of some SIMPLE-IRA distributions) will not apply. Thus, an IRA custodian will normally be able to code most pre-59 1/2 distributions as a "1."

The purpose of the Code 1 is to inform the IRS and the recipient that most likely the 10% additional tax of Code section 72 is owed on a particular distribution(s).

The IRS instructions for Code 1 are:

Code 1 is to be used for "Early distribution, no known exception." Use Code 1 only if the employee/taxpayer has NOT reached age 59 1/2, and if none of the other exceptions under section 72 (q), (t) or (v) are known to apply. For example, if a distribution is made for medical or qualified higher education expenses, you probably do not know if any medical or qualified higher education expense exception under section 72(t)

applies. Therefore, use Code 1. However, if an early distribution is made from a qualified retirement plan because of an IRS levy under section 6331, use Code 2.

Note the IRS does not mention the first-time home buyer exception though it does mention the medical and qualified higher education expense exception. The reason most likely is—the financial institution serving as a persons' IRA custodian or trustee MAY also be the financial institution serving as the mortgage lender or originator for this person's loan. Because a determination would still need to be made that the home purchase would qualify as a first time home purchase, a financial institution will be supported if it decides to use Code 1 to report the distribution even if the customer tells you he or she is using it for a first-time home purchase. In this situation, as discussed below, we suggest you inform your customer how he or she will need to complete his or her tax return to claim the first-time home buyer exception. You may do so by making copies of this article.

The IRS instructions for Code 2 are:

Code 2 is to be used for "Early distribution, an exception applies (as defined in section 72 (q), (t) or (v)). Use Code 2 if the employee/taxpayer has not reached age 59 1/2 to indicate that an exception under section 72 (q), (t) or (v) applies. However instead of Code 2, use Code 3 or 4, whichever applies, for an early distribution due to disability or death. Also use Code 2 for a Roth conversion (an IRA converted to a Roth IRA) or reconversion if the participant is under 59 1/2 and for an early distribution made from a qualified retirement plan because of an IRS levy under section 6331.

When is Code 2 used by an IRA Custodian?

An IRA custodian should limit its use of Code 2 to when it knows the IRA accountholder has established a substantially equal periodic payment distribution schedule, when it knows the IRA accountholder has converted funds from a traditional IRA to a Roth IRA, and when the distribution has occurred because of an IRS levy.

Purpose of Form 5329

The Form 5329 is titled, "Additional Taxes Attributable to IRAs, Other Qualified Retirement Plans, Annuities, Modified Endowment Contracts and MSAs." Form 5329 generally must be completed by a taxpayer/IRA accountholder to set forth the additional taxes which he or she owes as follows: (1) 10% (or 25%) tax for not being 59 1/2; (2) 50% tax for not complying with the required distribution rules; (3) the 6% excise tax for excess contributions; and (4) 10% tax for certain withdrawals from an Education IRA.

When Is Form 5329 Required to Be Filed?

An IRA accountholder must file a Form 5329 for a tax year if any of the following apply:

(1) He or she did not receive a minimum required distribution (RMD). Note that there is no minimum amount specified. The Form 5329 is required to be filed no matter how small the missed RMD was.

(2) He or she received a distribution which is subject to the additional tax, but the Form 1099-R was prepared incorrectly because it did not have a Code 1 in box 7.

(3) He or she meets an exception to the 10% additional tax, but an exception is not listed in box 7. The fact that such a code

is not listed in box 7 does not necessarily mean the IRA custodian made an error. The IRA custodian may have made an error or the custodian may not have had sufficient information to know whether the accountholder met the exception's requirements. For example, it would be extremely rare for an IRA custodian to know if a taxpayer met the requirements for the medical expense exception or the payment of health insurance premiums.

(4) He or she received distributions from his or her education IRAs in excess of his or her qualified higher education expenses.

(5) He or she made an excess contribution to a traditional IRA, Roth IRA, Education IRA or to an MSA for the current year, or an excess from a prior year still exists.

Note that the requirement to file the Form 5329 is not dependent upon filing the standard Form 1040, 1040A, etc. In the above four situations, an IRA accountholder must file the Form 5329 regardless of having to otherwise file a tax return. The IRA accountholder does so by completing it and filing it with the IRS at the time and place he or she would have been required to file the Form 1040. The accountholder must be sure to include his or her address on page 1 and sign and date the form on page 2. If the accountholder has realized the return should have been filed for a prior year, he or she must use the Form 5329 for that year (e.g. the 1998 Form 5329). An accountholder is not required to file a Form 1040X (Amended U.S. Individual Income Tax Return) if there are no other changes to the tax return other

Form 5329 Department of the Treasury Internal Revenue Service	Additional Taxes Attributable to IRAs, Other Qualified Retirement Plans, Annuities, Modified Endowment Contracts, and MSAs (Under Sections 72, 530, 4973, and 4974 of the Internal Revenue Code) ▶ Attach to Form 1040. ▶ See separate instructions.	OMB No. 1545-0203 1999 Attachment Sequence No. 29												
Name of individual subject to additional tax. (If married filing jointly, see page 2 of the instructions.)		Your social security number : : : : : :												
Fill in Your Address Only If You Are Filing This Form by Itself and Not With Your Tax Return	Home address (number and street), or P.O. box if mail is not delivered to your home	Apt. no.												
	City, town or post office, state, and ZIP code	If this is an amended return, check here <input type="checkbox"/>												
If you are subject only to the 10% tax on early distributions, you may be able to report this tax directly on Form 1040 without filing Form 5329. See Who Must File on page 1 of the instructions.														
Part I Tax on Early Distributions Complete this part if a taxable distribution was made from your qualified retirement plan (including an IRA other than an education IRA), annuity contract, or modified endowment contract before you reached age 59½. If a distribution was incorrectly indicated on Form 1099-R as an early distribution (no known exception to the additional tax), or you received a Roth IRA distribution, see page 2 of the instructions. Note: You must include the taxable amount of the distribution on Form 1040, line 15b or 16b.														
1 Early distributions included in gross income. For Roth IRA distributions, see page 2 of the instructions 2 Early distributions not subject to additional tax. Enter the appropriate exception number from page 2 of the instructions: _____ 3 Amount subject to additional tax. Subtract line 2 from line 1 4 Tax due. Enter 10% (.10) of line 3. Also include this amount on Form 1040, line 53	<table border="1" style="width:100%; border-collapse: collapse;"> <tr><td style="width:20px;">1</td><td style="width:100px;"></td><td style="width:100px;"></td></tr> <tr><td>2</td><td></td><td></td></tr> <tr><td>3</td><td></td><td></td></tr> <tr><td>4</td><td></td><td></td></tr> </table>	1			2			3			4			
1														
2														
3														
4														
Caution: If any part of the amount on line 3 was a distribution from a SIMPLE retirement plan, you may have to include 25% of that amount on line 4 instead of 10%. See page 2 of the instructions.														

First-Time Home Buyer, Continued from page 2

than paying one or more additional taxes.

When Is Form 5329 NOT Required to Be Filed?

Even if an accountholder owes the 10% additional tax for an early distribution, the accountholder is not required to file Form 5329 if the distribution Code 1 is correctly shown in box 7 of the Form 1099-R. Instead, the accountholder multiplies the taxable amount of the distribution by 10% and enters the result on line 53. The taxable amount of the distribution is the part of the distribution to be reported on line 15b or line 16b of Form 1040 or on Form 4972. Also, the accountholder is to put "No" next to line 53 to indicate that he or she is not required to

file the Form 5329.

The Top Portion and Part I of Form 5329 Reads as above.

Purpose of Part I and Instructions to Complete

For the most part, the instructions are self-evident. The form is to be used to calculate the 10% (or 25%) tax due because an early distribution has been received.

However, the form is also used to tell the IRS why the 10% tax is not due even though it is an early distribution.

The accountholder uses Part I to indicate four things: (1) the total of his or her early distributions; (2) the amount of such early distributions which are not subject to the additional tax; (3) the amount of such early distributions which are subject to the

additional tax; and (4) the tax owing.

Note for line 2, the IRA accountholder must furnish an appropriate exception code as to why the 10% tax is not owing. The IRS has furnished the following exception codes. The only way the IRS verifies whether the accountholder is correct will be if the IRS audits that accountholder. The exceptions:

No. Exception

01 Distribution due to separation from service after reaching age 55 (applies only to qualified employee plans).

02 Distribution made as part of a series of substantially equal periodic payments (made at least annually) for your life (or life expectancy) or the joint lives (or joint life expectancies) of you and your designated beneficiary (if from a qualified employee plan, payments must

begin after separation from service).

03 Distribution due to total and permanent disability.

04 Distribution due to death (does not apply to modified endowment contracts).

05 Distribution to the extent you have deductible medical expenses that can be claimed on line 4 of Schedule A (Form 1040) (does not apply to annuity or modified endowment contracts).

06 Distributions made to an alternate payee under a qualified domestic relations order (applies only to qualified employee plans).

07 Distributions made to unemployed individuals for health insurance premiums (applies only to IRAs).

08 Distributions made for higher education expenses (applies only to IRAs).

09 Distributions made for purchase

First-Time Home Buyer,
Continued from page 3

of a first home, up to \$10,000 (applies only to IRAs).

10 Distributions due to an IRS levy of the qualified plan.

11 Other (see instructions below).

Note that Code 11 is used for "other." This is primarily used to inform the IRS that the Form 1099-R was issued in error because the accountholder was over 59 1/2 at the time of the distribution.

Conclusion. Many times accountants and tax preparers believe an IRA custodian should have used a code 2 rather than a code 1 on the Form 1099-R. Sometimes they are right (i.e. the accountholder did a Roth conversion), and then the IRA custodian must issue a corrected Form 1099-R. However, an IRA custodian need not issue a corrected Form 1099-R just because the accountant and tax preparer believe they have met the medical expense exception, the payment of health insurance premiums, the qualified higher education expense exception or the first time home-buyer exception. When such exceptions apply, it is the job of the tax preparer and the accountholder/taxpayer to complete and file the Form 5329.

TRANSFERS—WE MAY ALL LONG FOR THE GOOD OLD DAYS, BUT NEW RULES MUST BE ACKNOWLEDGED

Until January 1, 1998, the rules for an IRA transfer were simple. The IRS' longstanding administrative rule was that a transfer was not reportable on the forms 1099-R and 5498 because the funds had moved from one IRA (or plan) to the same type of IRA (or plan) and thus were not considered received by the accountholder for federal income tax purposes. The preferred administrative approach was to use an IRA transfer form which was executed by three parties: the IRA custodian which was to remit the funds, the IRA custodian which was to receive the funds, and the IRA accountholder's authorization.

Rules have changed. There is no longer just one type of IRA transfer—the traditional IRA-to-traditional IRA. The enactment of the Roth IRA laws, effective January 1, 1998, changed everything because such laws (and subsequent IRS rules made via

regulation) created three new types of IRA transfers for traditional and Roth IRAs. Transfers with respect to SIMPLE-IRAs and Education IRAs are not covered in this article.

Type #1: A transfer from a Roth IRA to another Roth IRA.

Type #2: A transfer can now be used to accomplish a conversion contribution from a traditional IRA.

Type #3: A transfer can also be used to recharacterize a contribution to a traditional or Roth IRA into a contribution to the opposite type of IRA. That is, one changes the type of contribution (traditional to Roth or Roth to traditional) by affecting a recharacterization. Three types of contributions are eligible to be recharacterized: an annual contribution, a rollover contribution, and a conversion contribution. As with a conversion contribution, a recharacterized contribution can be done with the same custodian handling both transactions (the deemed distribution and the deemed contribution) or it can be done with different IRA custodians. For

example, on 2-3-99 Josie Hill contributed \$2,000 to her Roth IRA with IRA custodian #1. On 3-1-00 she decides to recharacterize this contribution to be a traditional IRA contribution with IRA

custodian #2. As has been illustrated in numerous newsletter articles, there is much paperwork to be done by both the IRA custodian or custodians and the accountholder—instruct to recharacterize, prepare a Form 8606, and attach a written explanation to the IRS to be attached to one's tax return. An accountholder will normally find he or she benefits by recharacterizing versus withdrawing an excess contribution and then making a contribution to the other type of IRA, because the earnings are allowed to be recharacterized as well as the original contribution.

As much as we believe the IRS' decision to allow "reportable" transfers was unwise, the IRS has changed the rules. We now believe it is time to change existing administrative approaches to acknowledge that transfers may be made with respect to conversion contributions and recharacterization contributions. Why? People are definitely starting to transfer funds from their traditional IRA funds at Custodian #1 to a Roth IRA at Custodian #2 or vice versa.

We have set forth two administrative forms you may consider using: (1) Instruction & Authorization to Transfer Traditional IRA Funds to a Roth IRA; (2) Notice of Recharacterization of IRA Contribution.



Instruction & Authorization to Transfer Traditional IRA Funds to a Roth IRA

To: Current Traditional IRA Custodian/Trustee

Name _____
Address _____
City, State, Zip _____
Phone _____

I wish to convert the indicated portion of my traditional IRA to a Roth IRA. However, my Roth IRA is with a different custodian/trustee.

From: Traditional IRA Accountholder

Name _____
Address _____
City, State, Zip _____
Phone _____ SSN _____

The IRS has ruled that there are three methods to convert funds within a traditional IRA into a Roth IRA. These three methods are explained on the reverse side. The third method authorizes the method set forth in this form – the amount in a traditional IRA is to be transferred from the custodian/trustee of the traditional IRA to the custodian/trustee of the Roth IRA.

Roth IRA Custodian/Trustee

Name _____
Address _____
City, State, Zip _____
Phone _____

For federal income tax purposes, the traditional IRA custodian/trustee must treat this transaction as a distribution to the IRA accountholder and report it on the Form 1099-R. You will be required to include some or all of this amount in income. The receiving Roth IRA custodian/trustee must treat it as a conversion contribution and report it on the Form 5498.

Special Instructions and Certification by Accountholder to Current Traditional IRA Custodian/Trustee and to the Roth IRA Custodian/Trustee

I, the IRA accountholder of a traditional IRA, hereby request and direct the IRA custodian/trustee of my traditional IRA, to send the amounts indicated below from my traditional IRA to the custodian/trustee of my Roth IRA as indicated above. I request that the traditional IRA custodian/trustee send my IRA funds in Account _____ according to the following instructions:

____ Liquidate and send my entire IRA account balance immediately.

____ Liquidate and send the assets listed below at maturity.

Account #: _____ Maturity Date: _____

Account #: _____ Maturity Date: _____

____ Send the following dollar amount \$ _____

____ Send all assets "in kind" as listed here: _____

I understand that I have instructed you to liquidate certain assets. I am aware of the penalties or losses which may result from this instruction. You are to send a check payable to the custodian/trustee of my Roth IRA. I certify that I have established a Roth IRA with the Roth IRA custodian/trustee named above. My Roth IRA custodian/trustee agrees to accept these funds as a Roth conversion contribution. I also herein instruct the custodian/trustee of my traditional IRA not to send any required minimum distribution amount that I am required to take for this year.

I expressly certify that I am responsible for determining my eligibility for such rollover and understand that I should consult my tax and legal advisor because of the complexity and importance of this matter. I understand that for tax purposes this transaction will be treated as a distribution from my traditional IRA and a conversion contribution into my Roth IRA. I furnish the following information regarding withholding.

Substitute
FORM W-4P

Withholding Certificate for IRA Pension or Annuity Payments OMB NO. 1545-0415

Department of the Treasury (IRS)

The instructions to this substitute Form W-4P are on the reverse side as well as additional discussion of special withdrawal topics.

Select #1 or #2 or #2 and #3.

1. I elect NOT to have income tax withheld from this IRA distribution.
2. I elect to have income tax withheld from this IRA distribution equal to 10% of the amount withdrawn. This amount is \$ _____
3. I want the following additional amount withheld from each IRA payment. \$ _____

Signature of Accountholder _____ Date _____

Special Instructions and Certification by Roth IRA Custodian/Trustee

I, on behalf of the Roth IRA custodian/trustee, hereby certify that the Roth IRA which will receive the transfer conversion contribution is a Roth IRA within the meaning of section 408(A) of the Internal Revenue Code.

Signature of Roth IRA Custodian/Trustee _____ Date _____

Acknowledgement of Current Custodian/Trustee and Instruction to IRA Accountholder

We have received your request to transfer your IRA funds to a successor Roth IRA custodian/trustee. We agree to do so only if you and the successor custodian/trustee have signed this form.

Signature of Current Traditional IRA Custodian/Trustee _____ Date _____



Notice of Recharacterization of IRA Contribution

To: Current Custodian/Trustee

Name: _____
 Address: _____
 City/State/Zip: _____
 Phone: (_____) _____

Date: _____

From: Depositor or Grantor

Name: _____
 Address: _____
 City/State/Zip: _____

SSN: _____
 Date of Birth: _____
 Phone - Home: _____
 Work: _____

I hereby instruct you that I wish to irrevocably recharacterize my previous contribution. The successor IRA will be with the current custodian/trustee or a successor custodian/trustee as indicated below. If I have indicated a successor custodian/trustee, then you are to issue a check for the amount indicated below to the successor custodian or trustee. I understand I must provide the following information to have my previous contribution recharacterized:

The Original Contribution

Account Number: _____
 Date of Contribution: _____
 Amount: _____

The Recharacterized Contribution

Account Number: _____
 Date of Contribution: _____
 Amount: _____

Type of Original Contribution (Check only one)

- 1. Conversion/Rollover to Roth IRA _____
- 2. Annual Contribution to a Roth IRA for _____ tax year _____
- 3. Annual contribution to a traditional IRA for _____ tax year _____

Type of Recharacterized Contribution

- 1. Rollover to a traditional IRA
- 2. Annual contribution to a traditional IRA for the same tax year
- 3. Annual Contribution to a Roth IRA for the same tax year

Instruction and Amount to Recharacterize

I elect to recharacterize \$ _____
 Which is all or a portion of my original contribution.

It is adjusted by:

- a. Related Earnings (losses) _____
- b. Interest Penalty Fee _____
- c. Administrative Fee _____
- d. Other _____
- e. Recharacterized Net Amount _____

I instruct you to transfer the recharacterized net amount to the successor custodian/trustee. I want this recharacterized net amount to come from the following assets held within my referenced IRA and paid in the instructed manner. I understand that there may be various fees associated with liquidating and/or transferring such assets in kind. These fees are set forth above. I authorize you to deduct such fees from the IRA.

- Liquidate all my accounts and transfer the cash proceeds by sending a check to the successor custodian/trustee;
- Liquidate the accounts I specify below and transfer the cash proceeds by sending a check to the successor custodian/trustee: _____
- Transfer all such assets "in kind" to the successor custodian/trustee;
- Transfer "in kind" the assets I specify below to the successor custodian/trustee: _____

I acknowledge that you have instructed me to consult with my legal or tax advisor because of the complexity and importance of this matter. This recharacterization is being made on or before the due date (including extensions) for filing my individual Federal income tax return for the taxable year for which the contribution was made. I expressly assume all responsibility for this recharacterization of IRA funds. I realize that my election to recharacterize my contribution is irrevocable.

Signature of Depositor or Grantor: _____ **Date:** _____

Acknowledgment of Current IRA Custodian/Trustee:

We acknowledge receiving your recharacterization instruction. We will report the original contribution on Form 5498, showing the character of the contribution (annual, conversion, etc.) and will report the distribution for recharacterization on Form 1099-R per the current IRS instructions. If your recharacterized contribution has been made into an IRA that you maintain with us, then we will also report the aforementioned contribution as a rollover on a Form 5498.

Signature of Current Custodian/Trustee: _____ **Date:** _____

Acceptance by Successor IRA Custodian/Trustee:

We, the successor custodian/trustee, agree to report this recharacterized contribution as identified above as a rollover contribution on Form 5498 and agree to accept this contribution as if it had originally been made to us rather than the previous trustee/custodian.

Successor Custodian/Trustee: _____ **Phone:** _____

Address: _____

City/State/Zip: _____

Signature of Successor Custodian/Trustee: _____ **Date:** _____

FMV FOR IN-KIND DISTRIBUTIONS AND COST BASIS

It is quite common for a self-directed or trustee IRA to distribute an in-kind asset to the IRA accountholder. For example, an IRA accountholder's IRA holds 1,000 shares of Microsoft stock, and her RMD for 2000 is \$4,000. If the stock has a value of \$80 per share, then the IRA trustee may distribute 50 shares to the IRA accountholder.

What value does an IRA custodian or trustee use as the distribution value (for Form 1099-R purposes) for an in-kind distribution?

You use the fair market value of the asset as of the time of the distribution. Special rules apply if the property being distributed is employer stock. These special employer stock rules are not discussed in this article because an IRA never holds employer stock, as that term is defined in the Internal Revenue Code.

Regulation 1.402(a)-1(a)(1) (iii) is set forth below:

(iii) Except as provided in paragraph (b) of this section, a distribution of property by a trust described in section 401(a) and exempt under section 501(a) shall be taken into account by the distributee at its fair market value. [Amended March 27, 1964, by T.D. 6717.]

This regulation should apply to IRAs just as well as to qualified plans. Note that it is the fair market value as of the exact time of day of the distribution and not as of the day of distribution (since stock or other assets may change value hourly or even more frequently). One must do the best job one can to determine this value.

Once the asset is distributed, then what value is used as the recipient's basis so that future capital gains or losses may be determined?

The general rule is, you use the fair market value of the distributed assets as of the time of distribution. Special rules apply if the property being distributed is employer stock. The general rule applies to all property other than employer stock.

What "authority" exists for using the fair market value as of the time of distribution for both taxation purposes and for subsequent basis determinations?

The standard capital gain rules of the Internal Revenue Code have little application to IRAs

and pension plans and to distributions from IRAs and pension plans. This is true for at least two reasons.

First, IRAs and qualified pension plan trusts have been given the special tax treatment of not being required to pay income taxes on the earnings of the trust as long as it is "qualified." It does not matter if an IRA makes ordinary income, short term capital gains or long term capital gains, because tax is not paid on any of the income, let alone a different rate for different types of income (i.e. lower rate for capital gains).

Second, the recipient of a distribution from a traditional IRA will generally have to include the entire amount distributed in his or her income. The amount being distributed is not characterized for any purpose as being contributions or earnings. Since January 1, 1987, the concept of basis has applied to traditional IRAs. Basis exists to the extent that a person has made nondeductible contributions and has not had those nondeductible contributions returned to him or her. Under section 72, a special pro rata rule applies to determine the taxable and non-taxable portions (i.e. return of basis) of a distribution.

A brief summary of the law follows:

The primary tax rule for IRA distributions is found in Code

section 408(d)(1), "In general. – Except as otherwise provided in this subsection, any amount paid or distributed out of an individual retirement plan shall be included in the gross income by the payee or distributee, as the case may be, in the manner provided under section 72."

The rule of Code section 408(d)(1) was written to follow the rule which had been written earlier in Code section 401(a)(1) for distributions from qualified plans. It reads, "Taxability of Beneficiary of Exempt Trust. – Except as otherwise provided in this section, any amount actually distributed to any distributee by an employee's trust described in section 401(a) which is exempt from tax under section 501(a) shall be taxable to the distributee, in the taxable year of the distributee in which distributed, under section 72 (relating to annuities)."

Code section 1012 provides the general rule for determining basis of property—the basis will be the cost of such property. It is logical that the fair market value of the property distributed is considered to be the equivalent of the cost so that it becomes the basis of the property for future calculations.



QA

QUESTIONS ABOUT ROTH IRAS

MY SPOUSE IS AN ACTIVE PARTICIPANT IN HIS EMPLOYER'S 401(k) PLAN. DOES THIS MAKE ME INELIGIBLE TO MAKE A CONTRIBUTION TO A ROTH IRA?

No. Although your spouse being an active participant may affect how much of your traditional IRA contribution is deductible, your spouse's participation in his or her employer's 401(k) plan has no such adverse effect.

I AM A PARTICIPANT IN MY EMPLOYER'S 401(k) PLAN. DOES THIS MAKE ME INELIGIBLE TO MAKE A CONTRIBUTION TO A ROTH IRA?

No.

IF I WOULD SET UP MY ROTH IRA ON 4-17-00 AND DESIGNATE THE CONTRIBUTION FOR TAX YEAR 1999, WHEN IS THE FIVE-YEAR PERIOD CONSIDERED TO HAVE STARTED FOR PURPOSES OF DETERMINING IF A DISTRIBUTION FROM MY ROTH IRA IS A QUALIFIED DISTRIBUTION?

The starting period is January 1, 1999. There is only another 3 3/4 years remaining to satisfy the five-year period requirement.

WILL A CONTRIBUTION OF A NOMINAL AMOUNT SUCH AS \$25 ON 4-17-00 START THE FIVE-YEAR PERIOD RUNNING JUST AS WELL AS A CONTRIBUTION OF \$2,000?

Yes.

IS IT PERMISSIBLE FOR THOSE INDIVIDUALS WHO CAN NO LONGER MAKE A CONTRIBUTION TO A TRADITIONAL IRA BECAUSE THEY ARE 70 1/2 OR OLDER TO MAKE A CONTRIBUTION TO A ROTH IRA?

Yes. However, such an individual must have qualifying compensation and his or her modified adjusted gross income must be less than \$160,000 for married filing jointly, \$10,000 for married filing separately, and \$110,000 for single and head of household filers.

Qualifying compensation is wages, salaries, tips, professional fees, bonuses and other amounts received for personal services. It also includes commissions, self-employment income and taxable alimony and separate maintenance payments.

IS IT PERMISSIBLE FOR A CHILD TO ESTABLISH AND FUND A ROTH IRA OR TO HAVE A ROTH IRA ESTABLISHED FOR THEM?

Yes. Proper documentation should be used so that one can substantiate that the child had the qualifying compensation.

IF A PERSON WHO QUALIFIES TO CONVERT HER TRADITIONAL IRA HAS \$40,000 IN SUCH IRA, IS THERE ANY TAX RULE WHICH PREVENTS HER (IT IS ASSUMED SHE QUALIFIES TO DO THE CONVERSION) FROM CONVERTING \$12,000 IN 2000, \$13,000 IN 2001 AND \$15,000 IN 2002?

No. A person may convert any portion of his or her traditional IRA. There is no minimum or maximum amount which may be converted.

IS IT POSSIBLE TO USE A ROTH IRA TO ACCUMULATE FUNDS TO BE USED FOR A FIRST-TIME HOME PURCHASES?

Yes. See the separate article in this newsletter discussing the various tax attributes.

IS IT POSSIBLE TO USE A ROTH IRA TO ACCUMULATE FUNDS TO BE USED TO PAY QUALIFYING EDUCATION EXPENSES?

Yes, but a portion of such distributions from a Roth IRA will be includible in income. Remember that distributions from a Roth IRA come out in the following order: (1) annual contributions; (2) conversions contributions; and (3) the income.

The annual contributions and the conversion contributions have already been taxed so they are not included in income. They certainly may be withdrawn and are a source to pay education expenses.

The income will not be taxable when the five-year holding requirement has been met and the distribution is on account of being age 59 1/2 or older, the disability of the account holder, the use of the funds for a first-time home purchase or the death of the account holder. Thus, withdrawing the income from a Roth IRA to pay education expenses will need to be included in income unless the account holder is over 59 1/2 or disabled. However, the 10% additional tax will not be assessed.