THE Pension Digest

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ALSO IN THIS ISSUE –

Permissibility of Waiving the Early Withdrawal Interest Penalty, *Page 5*

Not All States Allow HSA Deductions – Tax Complications, *Page 6*

IRA Statistics, *Page 8*

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IRAs and Bankruptcy

The U.S. Supreme Court recently ruled that a person filing for bankruptcy under Chapter 7 of the Bankruptcy Code is entitled to claim their IRAs as being exempt from the bankruptcy estate, and, therefore, IRA assets are not available to be disbursed to the bankruptcy trustee, nor, ultimately, to the individual's creditors. The exemption allows the individual to retain the IRA assets, and such assets are not allocated among creditors.

The specific case is, "Richard Gerald Rousey, et ux., v. Jill R. Jacoway, 544 U.S. (2005). The Court decision was unanimous.

There had been a split in the circuit courts as to whether or not IRA funds could be claimed as exempt property. The Eighth Circuit Court had ruled, (in this case and in many prior cases) that an IRA could NOT be claimed as exempt property, since the debtor did not have the right to receive payment "on account of age." The Ninth Circuit Court had ruled, in a number of cases, that an IRA could be claimed as exempt property.

General Discussion

When an individual files for bankruptcy under Chapter 7, the individual has the choice of using either the exemptions granted by the laws of the state of the debtor's residence, or by federal law. Many times the state laws will place limits on the amount which can

Continued on page 2

Miscellaneous Facts About IRAs, SEP-IRAs, and SIMPLE-IRAs

The IRS has written the following questions and answers with the purpose of providing general information. With respect to some of the Q/As, CWF has added an observation.

Can I contribute to a traditional IRA if I have other retirement plans?

Yes, you can contribute to a traditional IRA whether or not you are covered by another retirement plan. However, you may not be able to deduct all your contributions if you or your spouse is covered by an employer-sponsored retirement plan.

CWF Observation.

Note the question relates to a traditional IRA. An individual is always eligible to contribute an annual contribution to a Roth IRA as long as he or she has compensation and meets certain income limits.

Can I deduct losses in my IRA accounts on my income tax return?

No, neither IRA losses nor IRA gains are taken into account on your tax return.

CWF Observation.

The above rule applies to both traditional IRAs and Roth IRAs.

Continued on page 2

IRAs and Bankruptcy,
Continued from page 1

be exempted. The federal bankruptcy law does provide an exemption, but only to the extent that it is reasonably necessary to support the debtor.

No one likes to be ignored, and the U. S. Supreme Court is no exception. In its summary of the case, the Court expressly states that it "reaffirms its suggestion in Paterson v. Shumate, 404 U.S. 753, 762-764, that IRAs like the Rousey's can be exempted from the bankruptcy estate pursuant to section 522(d)(10)(E). The Court unanimously ruled that the Rousey's were entitled to exempt their IRAs from the bankruptcy estate, if such funds are reasonably necessary to support themselves or their dependents.

11 U.S.C. section 522(d)(10)(E) provides that a debtor may withdraw from the bankruptcy estate his "right to receive " — "(E) a payment under a stock bonus, pension, profit sharing, annuity, or similar plan or contract on account of illness, disability, death, age or length of service, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor..."

Paragraph (E) sets forth two requirements. The first requirement is that the payment be "on account of illness, disability, death, age, or length of service." The U.S. Supreme Court found that the Rousey's right to receive payments from IRAs is casually connected to their age. The IRS found the 10% additional tax penalty to be substantial. Such penalty does place a substantial restriction on distributions. This is so even if the law does provide some narrow exceptions. Such exceptions are limited in amount and scope. Such exceptions also apply to distributions from pension plans, and strengthen the argument that IRAs are similar to the listed plans. The 10% additional tax applies to most distributions when the recipient is younger than age 59½. At age 70½ and older, mandatory distributions are required. Clearly, distributions from IRAs are sufficiently on account of age, and they are clearly impacted by age. Therefore, the age requirement was met.

The second requirement was that the payment be under a plan similar to a pension, profit sharing, annuity or stock bonus plan. The Court found an IRA to be sufficiently similar to such plans. The common feature of all of these plans is that they provide income that substitutes for wages earned as salary or hourly compensation. An IRA does the same thing.

Miscellaneous Facts,
Continued from page 1

My bank refuses to give me a loan from my IRA-based plan. Isn't it required to allow loans?

IRAs are the investment vehicles for SEPs, SIMPLE-IRA plans and Payroll Deduction IRAs… IRAs do not permit loans. So your bank isn't allowed to give you a loan from your IRA.

CWF Observation.

CWF believes the chances are very slim that federal income tax laws will ever be changed to allow a person's IRA to be able to lend funds to that person or a related family member.

Can I roll over into my IRA the remaining loan balance I have from my retirement plan and make the loan payments to my IRA instead of the other plan?

IRAs do not permit loans. Therefore, repaying a loan balance from one plan by transferring the loan balance and making loan payments to your IRA is not allowed. If you attempted this transaction, the loan would be treated as a distribution at the time of the attempted rollover.

CWF Observation #1.

The IRS answer is incorrect. The IRS should have stated that IRAs do not permit "personal" loans. That is, funds may not be loaned to the IRA Accountholder, certain family members and certain controlled businesses. It is permissible for an IRA to lend funds to an unrelated third party, be it a corporation or an individual.

CWF Observation #2.

Many times a qualified plan is written to authorize a loan to a plan participant. The IRS has stated it will be permissible for a person to roll over funds from their IRA into a qualified plan. If such plan authorizes a loan to a participant, the amount the participant is entitled to borrow will be based on his or her entire account balance, including the amount rolled over from the IRA.

Continued on page 3

The Pension Digest

Miscellaneous Facts, Continued from page 2

If I have a Limited Liability Corporation (LLC), what IRA-based plans are available to me?

SEPs, SIMPLE-IRA plans and Payroll Deduction IRAs are all available to an LLC. As a general rule, these plans are available to any small business, including a business with only one employee and a business with only a self-employed employee.

What if there are no common-law employees?

It doesn't matter if there are no common-law employees.

Are employees/owners of an LLC considered "employees" for purpose of a retirement plan?

Any employees/owners of an LLC with earned income or compensation from the LLC are treated as employees for purposes of the Internal Revenue Code.

What is the deadline for establishing a SEP or a SIMPLE-IRA plan?

You can establish a SEP for a year as late as the due date (including extensions) of your company's income tax return for that year.

You can establish a SIMPLE-IRA plan effective on any date between January 1 and October 1 of the year for which you make your first contribution. However, if you previously maintained a SIMPLE-IRA plan, you can set up a SIMPLE-IRA plan **effective only on January 1** of the year for which you make your first contribution. Also, a SIMPLE-IRA plan cannot have an effective date before you actually adopt the plan.

CWF Observation.

Extension will apply for SEPs, but not for SIMPLE-IRAs. If an employer has never sponsored a SIMPLE-IRA, then the deadline to establish the plan is October 1 of the current year. For example, if an employer wishes to establish a SIMPLE-IRA for 2005 tax purposes, it must sign the plan document by 10-1-05. The deadline of 4-15-06 (plus extensions) does NOT apply. Some accountants and attorneys try to argue that the October 1 deadline does not apply if the employer is a sole proprietor. It does.

Do I qualify to set up a SEP or a SIMPLE-IRA plan?

Any employer can establish a SEP. However, if you establish a SEP, you may be restricted in maintaining another plan at the same time. Note that Salary Reduction SEPs (SAR-SEPs) cannot be established after 1996.

Generally, only an employer with 100 or fewer employees can establish a SIMPLE-IRA plan. If you establish a SIMPLE-IRA, you cannot maintain any other retirement plan at the same time.

How do I amend my SEP or SIMPLE-IRA plan for EGTRRA?

If you're using a prototype plan, you will receive an amended plan from the financial institution that provided you with the plan. If, for some reason, you don't receive (or haven't yet received) a new plan document, contact your financial institution.

While the financial institution provides many administrative services for your plan, it is the responsibility of you – the plan sponsor – to ensure that the plan is kept up to date with current law.

If you're using a Model plan, you should have already adopted an updated Model plan by the end of 2002. See Form 5305-SEP, Form 5305-A SEP, Form 5304-SIMPLE, or Form 5305-SIMPLE.

What is the timeframe for depositing contributions into SIMPLE-IRAs and SEP-IRAs?

You must make the salary reduction contributions to the SIMPLE-IRA as soon as possible, but no later than 30 days after the end of the month in which the amounts would otherwise have been payable to the employee in cash. For example, if your employees would have otherwise received compensation (instead of the elective deferrals) in March, you must deposit the deferral amounts as soon as possible, but no later than April 30.

You must make other contributions – matching or non-elective – by the due date (including extensions) for filing your federal income tax return for the year.

Continued on page 4

**Miscellaneous Facts,
Continued from page 3**

CWF Observation.

The IRS does not discuss the deadline for a self-employed individual. The conservative approach is to make the contributions by January 30 of the following year. It certainly could be argued that this rule should and does not apply to a self-employed individual.

Are there any restrictions on the things I can invest my IRA in?

The law does not permit IRA funds to be invested in collectibles such as:

- Artwork
- Stamps
- Rugs
- Antiques

The law also does not allow IRA funds to be invested in life insurance contracts. See Code section 408(m) for additional investment restrictions.

Finally, IRA trustees are permitted to impose additional restrictions on investments. For example, because of administrative burdens, many IRA trustees do not permit IRA owners to invest IRA funds in real estate. IRA law does not prohibit investing in real estate, but trustees are not required to offer real estate as an option.

CWF Observation.

Real estate is a permissible investment for an IRA unless a prohibited transaction would occur. Many IRA custodians and trustees choose to not allow an IRA accountholder to invest in real estate. This is done for administrative reasons, and concerns about possible liability if a prohibited transaction would occur.

Are the investment rules different for SEPS and SIMPLE-IRA Plans?

The investment vehicle – an IRA for these plans is the same. So, the investment restrictions for one are the same as for the other.

What are the notification requirements to participants, etc., when a plan terminates?

When terminating a Payroll Deduction IRA, a SEP or a SIMPLE-IRA plan, you must notify your employees that the plan has been discontinued. You may need to notify the financial institution that you chose to handle the plan that you will no longer be making contributions.

You may also need to let the institution know that you will terminate the contract or agreement with it. **You don't need to notify the IRS** of the plan's termination.

Do I still have to fund my plan in the year of termination?

SEPs and Payroll Deduction IRAs can be terminated at any time, provided the employees are notified. You can stop funding these plans once they are terminated.

However, SIMPLE-IRA plans are maintained and terminated on a calendar-year basis. Therefore, you must notify participants this year that you are terminating the plan prospectively for the next calendar year. Practically speaking, once the calendar year starts and you have a SIMPLE-IRA plan, you must fund it for the whole year.

I am receiving distributions of substantially equal payments from my IRA in order to satisfy the minimum distribution rules, and, therefore, avoid the 10% additional tax under Code section 72(t). May I change my substantially equal payments because of the downtrend in the stock market?

Let's explain a bit about the 10% additional tax under Code section 72(t) first. The Code section applies a 10% tax on distributions from an IRA unless the recipient meets one of several exceptions: such as being over age 59½ or being a beneficiary after the death of the holder of the IRA.

An exception to the 10% additional tax for an IRA owner younger than age 59½ occurs when the recipient receives their distributions as part of what is called a "series of substantially equal periodic payments." A series of substantially equal periodic payments are payments based on the life expectancy of the recipient (or expectancies, if there is more than one recipient.)

For example, assume Peter is age 52 and still working. Peter wants to start receiving distributions from an IRA that he has, but not incur the additional 10% tax

Continued on page 5

The Pension Digest

**Miscellaneous Facts,
Continued from page 4**

of section 72(t). After speaking with his IRA trustee, Peter discovers that someone age 52 has a remaining life expectancy of 24 years. Peter and the IRA trustee then base Peter's distributions on the 24 years figure. Because Peter's distributions are based on his life expectancy – even though he is younger than age 59½ his distributions are not subject to the additional 10% tax under section 72(t). Of course, the distributions are still subject to regular income tax.

Now as for the question above, regarding whether someone can make a change in a series of substantially equal periodic payments. Generally, the answer would be "yes," but you would be subject to the 10% additional tax imposed under section 72(t). However, Revenue Ruling 2002-62 provides for a one-time modification without the imposition of the 10% tax section 72(t). But any later change would trigger the 10% additional tax under section 72(t).

Permissibility of Waiving the Early Withdrawal Interest Penalty

What are the rules pertaining to assessing or waiving an early withdrawal interest penalty for an early withdrawal from an IRA time deposit or savings account?

There are situations where assessing an early withdrawal penalty is mandatory — such penalties apply to early withdrawals from time deposits. Such penalties do not apply to early withdrawals from savings accounts. By definition, a savings account does not have a term or a maturity date. Consequently, there is no early withdrawal penalty related to withdrawing funds from a savings account.

A penalty is mandated for early withdrawals from all time deposits, not just from IRA time deposits. A portion of the applicable Federal Reserve Regulations are reproduced here:

Federal Reserve Regulation section 217.4 — Payment of Time Deposits Before Maturity

(d) Penalty for Early Withdrawals

(iv) The following minimum early withdrawal penalty shall apply to time deposit contracts entered into, renewed, or extended on or after October 1, 1983:

(A) Where a time deposit with an original maturity or required notice period of seven to 31 days, or any portion thereof, is paid before maturity, a depositor shall forfeit an amount at least equal to the greater of (1) all interest earned on the amount withdrawn from the most recent of the date of deposit, date of maturity, or date on which notice of withdrawal was given, or (2) all interest that could have been earned on the amount withdrawn during a period equal to one-half the maturity period or the required notice period.

(B) Where a time deposit with an original maturity or required notice period of 32 days to one year, or any portion thereof, is paid before maturity, a depositor shall forfeit an amount at least equal to one month's interest earned, or that could have been earned, on the amount withdrawn at the nominal (simple interest) rate being paid on the deposit, regardless of the length of time the funds withdrawn have remained on deposit.

(C) Where a time deposit with an original maturity or required notice period of more than one year, or any portion thereof, is paid before maturity, the depositor shall forfeit an amount at least equal to three months' interest earnings, or that could have been earned, on the amount withdrawn at the nominal (simple interest rate being paid on the deposit, regardless of the length of time the funds withdrawn have remained on deposit.

(2) Notwithstanding the provisions of paragraph (d)(1), where a time deposit, or any portion thereof, maintained in an Individual Retirement Account established in accordance with 26 U.S.C. 408 is paid before maturity within seven days after the establishment of the Individual Retirement Account pursuant to the provisions of 26 CFR 1.408(1)(d)(4), or where a time deposit, or any portion thereof, maintained in a Keogh (H.R. 10) Plan account established in accordance with 26 U.S.C. 401 is paid before maturity within seven days after the establishment of the Keogh (H.R.10) Plan, a depositor shall forfeit an amount at least equal to the interest earned on the amount withdrawn at the nominal (simple interest) rate being paid on the deposit.

(3) A member bank, with the depositor's consent, may compute the minimum penalty required to be imposed on withdrawals from time deposits opened

Continued on Page 6

Early Withdrawal Interest Penalty, Continued from page 5

prior to June 2, 1980, on the basis of the nominal (simple interest) rate.

(4) Where necessary to comply with the requirements of this paragraph, any interest already paid to or for the account of the depositor shall be deducted from the amount requested to be withdrawn.

(5) Any amendment of a time deposit contract that results in an increase in the rate of interest paid or in a reduction in the maturity of the time deposit before maturity.

(6) For purposes of computing the penalty required to be imposed under this paragraph, under a time deposit agreement that provides that subsequent deposits reset the maturity of the entire account, each deposit maintained in the account for at least a period equal to the original maturity of the deposit may be regarded as having matured individually and been redeposited at intervals equal to such period. Except as provided in subparagraphs (1)(iii)(E) and (1)(iv)(A), when a time deposit is payable only after notice, for funds on deposit for at least the notice period, the penalty for early withdrawal shall be imposed for at least the notice period.

(7) A member bank may permit a depositor to withdraw interest credited to a time deposit during any term at any time during such term without penalty. If the deposit or account is automatically renewed on the same terms (including at the same rate of interest), interest credited during the preceding term or terms as well as the renewal term may be paid at any time during the renewal term without penalty, unless the deposit agreement specifically provides otherwise. If the rate of interest paid during the renewal term or the maturity period of the renewal term is different, interest in the account at the commencement of the renewal term shall be treated as principal, and only interest for the renewal term may be paid at any time without penalty during such term.

(8) A time deposit, or a portion thereof, may be paid before maturity without a forfeiture of interest as prescribed by this paragraph in the following circumstances:

(i) Where a member bank pays all or a portion of a time deposit representing funds contributed to an Individual Retirement Account or a Keogh (H.R. 10) Plan established pursuant to 26 U.S.C. (IRC 1954) 408, 401 when the individual for whose benefit the account is maintained attains age 59½ or is disabled (as defined in 26 U.S.C. (IRC 1954) 72(m)(7)) or thereafter; or

(ii) Where a member bank pays that portion of a time deposit on which Federal deposit insurance has been lost as the result of the merger of two or more Federally insured banks in which the depositor previously maintained separate time deposits, for a period of one year from the date of the merger.

(9) A time deposit, or the portion thereof requested, must be paid before maturity without a forfeiture of interest as prescribed by this paragraph in the following circumstances:

(i) Where requested, upon the death of any owner of the time deposit funds; or

(ii) Where requested, when the owner of the time deposit is determined to be legally incompetent by a court or other administrative body of competent jurisdiction."

CWF Note: Be aware that the fees listed are the required minimum interest penalty; an institution could charge a larger fee. If your institution does not assess early withdrawal penalties on time deposits, and if bank regulators became aware of this situation, the bank could face penalties.

For your information, CWF has a series of forms on which a bank's early withdrawal fees can be detailed. Call our sales department for details.

Not All States Allow HSA Deductions — Tax Complications

Even though deductions are allowed for Health Savings Accounts (HSAs) on an individual's federal income tax return, not all states allow this deduction. Such states generally require that an individual add their HSA contributions back to their federal adjusted gross income to arrive at the amount taxable under state law. Listed below are the various states and whether or not they allow the HSA deduction.

Continued on page 7

The Pension Digest

Not All States Allow HSA Deductions, Continued from page 6

Category #1 — States with no state income tax (not affected by HSA deductibility for state income tax purposes)

Alaska	New Hampshire	Texas
Florida	South Dakota	Washington
Nevada	Tennessee	Wyoming

Category #2 — States that have authorized HSAs (follow federal income tax law with respect to HSAs)

Arizona	Iowa	North Carolina
Colorado	Kansas	North Dakota
Connecticut	Louisiana	Ohio
Delaware	Maryland	Oklahoma
DC	Michigan	Oregon
Georgia	Missouri	Rhode Island
Hawaii	Montana	South Carolina
Idaho	Nebraska	Utah
Illinois	New Mexico	Vermont
Indiana	New York	Virginia
West Virginia		

Category #3 — States that have NOT authorized HSAs (DO NOT follow federal income tax law with respect to HSAs)

Alabama	Maine	New Jersey
Arkansas	Massachusetts	Pennsylvania
California	Minnesota	Wisconsin
Kentucky	Mississippi	

Tax Complications

The fact that 11 states do not grant a tax deduction for HSA contributions does not mean that an individual domiciled in one of these states is ineligible to establish an HSA. HSA eligibility is determined by federal law, not state law. The federal income tax benefits will influence many individual to establish HSAs, regardless of state law. A Minnesota resident may establish an HSA, but he or she will not receive any tax benefits under Minnesota tax law for doing so. In fact, tax reporting and compliance is going to be extremely complicated. In Minnesota, because the tax deduction for the HSA contribution is not authorized, the individual is required to increase his or her federal adjusted gross income (i.e. add back) by the HSA contribution amount. Any contribution made by an employer will also need to be included in income for state income tax purposes, even though it is excluded for federal income tax purposes.

HSA distributions which are tax free for federal income tax purposes may be subject to some taxation by the state. When the individual withdraws his or her contribution, it will not be taxable, because it is just the return of his or her own after-tax money. When the individual withdraws earnings, that amount will be taxable. Individuals may want to wait until they are no longer a resident of such a state before taking distributions. There are no rules preventing a person from delaying reimbursement payments to themselves for previously-paid qualified medical expenses.

A person who accumulates money or assets in an HSA while a resident of a state which follows federal income tax law will not want to relocate to Minnesota or any other state which does not follow the federal HSA rules. By moving to Minnesota, an individual would make HSA distributions taxable when they otherwise would not have been.

Technically, the income being earned by the HSA accounts of Minnesota residents (or residents of any of the other 10 states in this category) is subject to current taxation by such state(s). Banks and other IRA custodians do not presently have the capability to report these earnings as taxable. Nor have the states said that this is a requirement. Minnesota apparently would not have the right to tax the income earned by the HSA of a nonresident. A bank in Iowa could make the sales pitch to Minnesota businesses and residents that they would be better off making their HSA contribution to an Iowa HSA custodian, since the Iowa bank will generally not owe tax duties to Minnesota. Although Minnesota could require a Minnesota resident to disclose and pay tax on the earnings of an HSA located in another state, presumably, they would not do so.

We at CWF believe these 11 states will, at some point, adopt the federal HSA laws, simply because of the tax complexities — obviously, the sooner, the better.

IRA Statistics

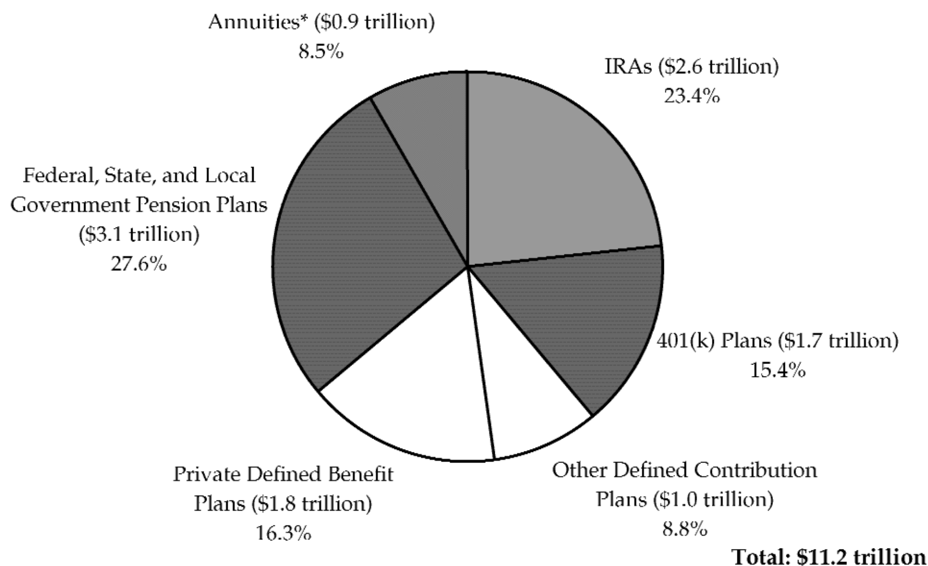
Figure 3. Individual Retirement Arrangement (IRA) Plans by type, Tax Year 2001

Type of plan	Beginning of year FMV		Total contributions		Deductible on Form 1040		Rollovers	
	Number of Taxpayers	Amount	Number of Taxpayers	Amount	Number of Taxpayers	Amount	Number of Taxpayers	Amount
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Total	46,270,141	2,629,309,067	15,987,806	36,524,664	4,504,937	13,167,381	3,602,806	187,080,603
Traditional IRA Plans	38,076,500	2,407,022,354	5,583,757	9,825,898	3,718,917	7,406,866	3,602,806	187,080,603
SEP Plans	3,313,204	134,047,902	1,786,931	10,071,870	642,053	4,991,601	n/a	n/a
SIMPLE Plans	1,568,426	10,351,751	1,728,736	5,468,896	143,966	768,913	n/a	n/a
Roth IRA Plans	9,485,189	77,579,420	6,806,294	11,116,124	n/a	n/a	n/a	n/a
Education IRA Plans 3/	241,238	307,640	82,088	41,876	n/a	n/a	n/a	n/a

Type of plan	Roth conversions		Withdrawals 1/		Other changes 2/	End of year FMV	
	Number of Taxpayers	Amount	Number of Taxpayers	Amount	Amount	Number of Taxpayers	Amount
	(9)	(10)	(11)	(12)	(13)	(14)	(15)
Total	0	0	9,185,958	104,527,365	-129,010,549	48,404,401	2,619,376,420
Traditional IRA Plans	255,062	-3,052,037	8,553,004	98,690,314	-107,320,567	39,283,457	2,394,865,938
SEP Plans	n/a	n/a	342,199	4,452,660	-8,305,687	3,523,805	131,361,424
SIMPLE Plans	n/a	n/a	98,049	471,710	-1,756,655	1,959,748	13,592,282
Roth IRA Plans	255,062	3,052,037	370,077	875,818	-5,874,730	11,026,390	79,349,804
Education IRA Plans 3/	n/a	n/a	73,919	36,863	-105,681	206,655	206,972

Note: Except as noted, all data are from matched forms 1040 and 5498; all figures are estimates based on samples--amounts in thousands of dollars.
1/ Withdrawals are reported on Form 1099-R; excludes withdrawals for the purpose of rollovers to other IRA accounts, or Roth IRA conversions.
2/ Residual of change in fair market value minus all the enumerated changes.
3/ Education IRAs were renamed Coverdell Education Savings Accounts (ESAs) in July 2001; excludes Ed-IRAs owned by non-filing dependents.
Source: Matched file of income tax returns, Forms 5498, and 1099-R for Tax Year 2001

Figure 1
U.S. Retirement Market, 2001



*Does not include annuities held in IRAs, 403(b) plans, 457 plans, or private pension plans.

Sources: Investment Company Institute, Internal Revenue Service, Statistics of Income Division, and Federal Reserve Board

Source: "Use of Individual Retirement Arrangements to Save for Retirement – Results From a Matched File of Tax Returns and Information Documents for Tax Year 2001," Peter Sailer, Statistics of Income IRS, and Sarah Holden, Investment Company Institute. January 2005.