

**PART I**

**Everything You Need to Know About  
Listed Transactions Connected with Benefit Plans**

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**2007 San Diego Tax & Accounting Institute**

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## **LISTED TRANSACTIONS IN CONTEXT OF LOCALLY PROMOTED 412(i) PLANS AND 419A(f)(6) OR 419(e) PLANS**

### Setting the Stage

Local insurance agents and Pension/Benefit Consultants are promoting use of three types of benefit programs for which virtually no one in this room should allow their clients to enter into (assuming you have some control over it). And if you or your clients do enter into such a benefit program - you need to exercise extreme caution to protect both yourself and your client. The notorious three are:

1. IRC § 412(i) fully insured Defined Benefit Plan with excess life insurance death benefit coverage. This is, and has been, potentially a “listed transaction” (described later) since spring 2004. A 412(i) Plan is a “listed transaction” for a given tax year if the face value of the life insurance death benefit provided to a participant is more than \$100,000 in excess of the maximum allowable death benefit for a Defined Benefit Pension Plan and a deduction is taken for a contribution to the Plan. Other problems include:

- Life insurance exceeding 50% of Plan assets (disqualifying feature) - these Plans must promptly provide annuity policy coverage.
- Benefits provided under annuity policy not equaling the benefits provided under the Plan document.
- Cash value benefits for owners - and term or “discriminatory” coverage for non-owners.
- Failure to cover sufficient personnel to pass coverage tests.
- Failure to implement annuity insurance benefit coverage during the Plan Year (the IRS position is the policy must be purchased during the applicable taxable year - no 81/2 month grace period to purchase policy even if the tax return is on extension (the full premium can be paid up until the return due date assuming the policy was in force as of the end of the tax year).

NOTE - This discussion will focus primarily on “listed transaction” issues.

2. IRC § 419A(f)(6) Welfare Plans - This is a type of “pooled” VEBA that is allegedly maintained by multiple employers. No one employer can contribute more than 10% of the total contributions. And the Plan will not qualify for any favorable tax deduction treatment if the Plan has “experience rated” arrangements under which each employer’s contributions and benefits are individually determined either on the contribution end or the benefit end - or both. A purported 419A(f)(6) Program that maintains experience rating for employers has been a “listed transaction” since Notice 2002-15. Other problems include:

- Contributions in excess of amounts deemed actuarially necessary to provide the cost of the death benefit (under “term coverage principles”).

- Severance or disability benefit features that are in effect, intended to operate as “non-qualified deferral compensation plans”. Deferred Compensation is NOT a permissible 419A(f)(6) benefit. And the Plan almost certainly can be deemed to violate IRC § 409A (a topic of its own).

- The Insurance Policies are almost always horrible economically: No one would buy them outside the context of a claimed big tax deduction.

- Funds are held by a third party trustee - out of client’s control. Think about the implications of that.

3. 419(e) Welfare Plan. This is a single employer VEBA. Heavily promoted by insurance agents in recent years/months, deductions to this type of Plan were specifically limited in the Tax Reform Act of 1984. The net import of these limits “killed” the single employer VEBA tax shelter market and led to the (largely abusive) 419A(f)(6) programs. IRC § 419(e)’s limits basically limit deductions to amounts the employer could otherwise deduct without the VEBA, with some minor exceptions. Post retirement medical and life insurance benefits cannot be funded to extent:

1. Life Insurance face value exceeds \$50,000.
2. Benefits do not cover a nondiscriminatory classification (IRC § 505(b)).
3. Benefits for key-employees (owners - IRC 416(i)) must be allocated to a separate account and allocations to this account reduce the maximum per person allocation of \$45,000 to a 401(k) or other Defined Contribution Plan.

The typical 419(e)Program marketed to businesses as tax shelters was designated a listed transaction on October 17, 2007 in Notice 2007-83 - for fiscal years ending on or after November 5, 2007.

What is a “listed transaction”?

IRC § 6707A imposes penalties upon any person who fails to include information with respect to a “listed transaction” which is required under IRC § 6011 to be included on the return. The net impact of 6011 and 6707 is that a “listed transaction” must be reported on Form 8886 to avert the penalty under IRC § 6707A(b)(2).

A “listed transaction” is defined in IRC § 6707A(c)(2) as “a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary (of the Treasury) as a tax avoidance transaction for purposes of Section 6011”.

### What is the Penalty?

The penalty is (per tax year) \$100,000 for a natural person and \$200,000 for any other case.

### What triggers the Penalty?

Deducting any amount (\$1?) on an applicable return with respect to a “listed transaction” without filing Form 8886.

### How is the penalty calculated by IRS in the field?

(Note: - this is based on current audit experience - trust me).

Sole proprietor - \$100,000 per year.

C corporation - \$200,000 per year (possibly penalty on shareholders if IRS successfully alleges “constructive dividend”).

LLC/General Partnership - \$100,000 per partner (assume taxed as a partnership).

S corporation - \$200,000 on corporation, \$100,000 per shareholder.

Example - 3 shareholders - \$200,000 on “S” corporation, \$300,000 on shareholders - Grand total - \$500,000 per year!

### Can the Friendly IRS Agent Waive the Penalty?

Not on paper. See IRC § 6707A(d)(1). Congress barred the IRS from this discretion.

### Can you appeal imposition of the penalty to US Tax Court or Federal District Court?

No. See IRC § 6707A(d)(2).

Can You Amend a Return to Add Form 8886 - and thus Avert the Listed Transaction Penalty? (this took some research and discussions with the IRS to dig out - the accounting profession is, per discussions with many, including Big Four, unaware of this).

Generally NO! See Reg 1. 6604 - 2(3)(ii).

The net import of this Reg (issued January 7, 2007) is that a “listed transaction” will be considered “undisclosed” unless Form 8886 is filed either on the original return or is filed with a “qualified amended return”. For purposes of a “listed transaction” an amended

return is not “qualified” unless filed before:

1. Date taxpayer is contacted by IRS for examination.
2. Date tax shelter promoter is contacted by IRS for examination under IRC § 6700 (penalty on promoter for promoting abusive shelters).
3. Date “pass-thru entity” is contacted by the IRS (for pass-thru tax item).
4. Date of summons to group including pass-thru entity or taxpayer.
- \*5. Date by which Commissioner announces a settlement initiative with respect to a listed transaction.

NOTE - The IRS HAS announced, in previous years, settlement initiatives for 419(A(f)(6) Welfare Plans and 412(i) Defined Benefit Plans. Thus, window on these is closed. As to 419(e) Welfare Plans (single employer) - I am not aware of any settlement initiative yet - thus AMEND or “face the music”.

NOTE - The Reg indicates Commissioner may waive the requirements of the settlement initiative bar. What does that mean? It means the IRS is not barred by Congress from waiving the settlement initiative prohibition - although in our experience thus far - IRS Field Agents and their immediate supervisors say “No”. Appeal to IRS Appeals might be needed - we are not far enough in that pipeline yet to know what happens at Appeal.

6. Date IRS contacts any person under IRC § 6707 for failure to report a “reportable transaction”.

7. Date IRS requests from any person who made a tax statement to or for benefit of taxpayer, or gave taxpayer material advice with respect to the information required to include on a list under IRC § 6112 relating to a transaction same or similar to the undisclosed listed transaction (IRC § 6112 relates to lists required to be maintained by material advisors (IRC § 6111)).

**TOUCH CHOICES!** Chart follows:

<u>Situation</u>	<u>What to do?</u>
<p>1. Client enters into “listed transaction”. You find out. Return not prepared or filed</p>	<p>Insist on attaching Form 8886 or backing out deductions or both: Explain reasons to Taxpayers. 8886 also goes in on 1040 for S corporation owners or LLC members. CYA if client refuses. Seriously consider revising returns to back out the affected deduction.</p>
<p>2. Client enters into “listed transactions”. Returns filed without 8886.</p>	<p style="text-align: center;"><u>412(i) or 419A(f)(6)</u></p> <p>Determine why you were unaware of “listed transactions” to measure exposure for 412(i) and 419A(f)(6). Measure “pros” of disclosing transaction on Form 8886 (guaranteed audit?) when there is only a small chance IRS Commissioner may waive the “listed transaction” penalty - and most likely backing out the deductions--or not disclosing - thereby playing the audit lottery (remember they can - and have - gotten the “promoters” list. I was told IRS got a list of most of BISYS’s 419A(f)(6) clients and is auditing <u>all</u> - and locally many of you know Xelan’s list is under audit) but having no chance of getting penalty waived. <u>NOTE</u> - Developing area. A middle step is not filing 8886 but amending to delete deductions (a “listed transaction” requires a “deduction”). We are currently testing whether that “works” - although an IRS Field Agent told me if “deduction taken on the original return, amending to delete it does not matter.”</p> <p style="text-align: center;"><u>419(e) Single Employer VEBA</u></p> <p>File amended return with 8886 - and for more protection - disallow deductions.</p> <p><u>NOTE</u>- Also, per Notice 2007-83: file Form 8886 for all open years - must be filed by January 15, 2008.</p>

## Do Taxpayers and or Promoters Usually Blame the CPA for the Imposition of a “listed transaction penalty?”

Absolutely! In experience of BUTTERFIELD SCHECHTER♦LLP, in connection with IRS audits and litigation against the promoter of these abusive employee benefit products - standard litany is: “we just sold the product and the plan, the filing of the Form 8886 is your accountant’s responsibility”! Even though the client usually is clueless as to what a “listed transaction” is - much less able to articulate to his/her CPA the fact he/she entered into an abusive tax shelter.

NOTE - Virtually all of these deals involve an insurance or financial person promoting these deals, assuring the client of wonderful tax write-offs and great financial/tax benefits and at the last moment (see form later) asking client to sign - in the flurry of paperwork needed to sign up for the program - to sign a disclaimer form to protect the promoter - the form usually says “you did not rely on the promoter for tax advice, obtained independent advice,” and some also indicate “the transaction might be a listed transaction” (see later slide). There are almost never any oral disclosures - or written disclosures prior to the final signing session - to the effect that the client is entering into an abusive tax shelter and that penalties in the hundreds of thousands of \$s can be imposed for failure to file Form 8886.

NOTE 2 - Virtually all (with exceptions) of the deals we’ve seen involve a CPA who just is “given pension/benefit #s” - and is uninvolved in the consulting process and also unaware of the nature of the particular benefit plan. The CPA claims ignorance of the situation - indicating he/she had no idea what taxpayer did was a “listed transaction” or was considered abusive in any way. This results in UGLY finger pointing situations - and possible litigation. Clients turn mean and nasty when penalties in the hundreds of thousands are imposed.

### Examples of the Ugliness

Our firm has numerous examples of disclosure forms taxpayers sign, and litigation postures. A sampling follows (actual form):

"TAXPAYER DISCLOSURE OF LISTED TRANSACTION

Name of Employer: \_\_\_\_\_

Federal Identification Number: \_\_\_\_\_

Name of Plan: \_\_\_\_\_

Plan Administrator: \_\_\_\_\_  
\_\_\_\_\_

I, the undersigned on behalf of the employer named above, hereinafter called the "EMPLOYER", hereby acknowledge and agree as follows:

1. I am duly authorized and empowered to execute this Acknowledgment and Waiver on behalf of said EMPLOYER;
2. The EMPLOYER has established a welfare benefit plan under the provisions of Internal Revenue Code section 419A(f)(6), and the Penn Mutual Life Insurance Company has issued or will issue life insurance policy(s) pursuant to the terms and provisions of said plan;
3. Under the provisions of Internal Revenue Code section 6011 and the Regulations thereunder, welfare benefit plans purporting to comply with the provisions of Internal Revenue Code section 419A(f)(6) may be considered "listed transactions", and therefore, the EMPLOYER may be required to file IRS Form 8886 - Reportable Transaction Disclosure Statement with its federal income tax return;
4. The provisions of American Jobs Creation Act of 2004 enacted on October 22, 2004 impose substantial monetary fines and tax penalties for noncompliance with the taxpayer disclosure requirements of Internal Revenue Code section 6011;
5. The EMPLOYER has relied solely and exclusively on the opinion and advise of its independent legal and tax advisors with respect to all matters relating to said plan, including, but not limited to the disclosure requirements and tax consequences of said plan;
6. Neither the Penn Mutual Life Insurance Company nor any of its agents, representatives, or employees have provided any legal or tax opinion or advise with respect to the tax consequences of the plan, taxpayer disclosure requirements, or the application and effect of the Employee Retirement Income Security Act of 1974 (ERISA) respecting the plan;
7. The undersigned EMPLOYER hereby agrees to indemnify and hold harmless the Penn Mutual Life Insurance Company and its agents, representatives, or employees from any and all liability obligation or responsibility whatsoever directly or indirectly relating to or resulting from the establishment, operation, or administration of the plan, the taxpayer disclosure requirements respecting said plan or the fines and penalties for noncompliance with said disclosure requirements and the tax consequences of said plan.

Date: \_\_\_\_\_

NAME OF EMPLOYER

ATTEST:

SIGNED:  
TITLE:

\_\_\_\_\_  
\_\_\_\_\_

And in litigation, the insurance company usually claims its agent was a “cowboy” - acting improperly. See the following excerpt from Hartford Insurance Company’s “answer” in litigation:

### “THIRD AFFIRMATIVE DEFENSE

#### No Reasonable Reliance

Defendants assert that Plaintiffs had the resources to engage, and did in fact engage, the services of independent advisors and experts to advise and assist them in conjunction with the events alleged in the Complaint. Defendants allege that Plaintiffs relied upon the advise and expertise of their own advisors in connection with the activities alleged in the Complaint. In addition, Defendants allege that Plaintiffs took tax deductions for Welfare benefit plan contributions and took other actions knowing they freely and voluntarily assumed the tax risks and other risks and consequential injuries and damages, if any, and could not and did not reasonably rely on any purported misrepresentation, inaction, advise or purported expertise of Defendants.”

What can you do to protect yourself Given the new paradigm that Insurance Agents - at least in this arena - are not your friends, are not fiduciaries of the taxpayer, and are hell-bent to market and sell abusive tax shelters to you and your clients - knowingly or not?

NOTE - Given some CPAs now sell product - participating in the advising and promotion of this type of Program from an investment fee perspective means litigators will almost certainly want to name you as a party Defendant. As it stands, even if you have no involvement in the investment side of this - you are likely to be named as a Defendant.

COVER YOUR BUTT!!!! Consider two things:

1. Amend your engagement letter (this is unlikely to work if you materially participated in the consulting and/or investment side of the listed transaction) to say something to the effect:

Acme CPAs does not in the gathering of data to prepare your returns (1040, 1120, 1065, etc.) independently investigate to determine whether the contributions reported to us by your Qualified Plan or Benefit Program Consultants, Insurance Agent or Third Party Administrators are to a program designated by the IRS as a “listed transaction” (i.e. abusive tax shelter). Penalties for unreported “listed transactions” can be \$200,000 or more per year.

We merely take information from others - the tax qualifications and other attributes of the benefit programs you contribute to are not our responsibility. Our firm can assist you upon request to review your benefit programs - and we will if deemed advisable - assist you to

obtain independent advice from qualified benefit advisors. The types of benefit programs particularly susceptible to "listed transaction" penalties generally are (1) 412(i) fully insured Defined Benefit Plans with life insurance (2) 419A(f)(6) multiemployer Welfare/VEBA Plans and (3) single employer 419(e) Welfare/VEBA Plans (not a complete list).

## 2. Annual Questions in your Questionnaire to Clients:

### Examples:

1. Did you establish or do you maintain any benefit plans of the following types during 2007?

A. 412(i) fully insured Defined Benefit Plan with life insurance. Yes \_\_\_ No \_\_\_

B. 419A(f)(6) Welfare Plan/VEBA. Yes \_\_\_ No \_\_\_

C. 419(e) Welfare Plan/VEBA. Yes \_\_\_ No \_\_\_

D. Any other type of benefit program involving life insurance or disability insurance premiums other than a "plain vanilla broad coverage" Section 79 Group life insurance plan or group disability plan. Yes \_\_\_ No \_\_\_

## 3. Get Suspicious!

Do you have a client 32 years old whose Pension consultant sends you a letter telling you the 2007 pension deduction is \$200,000+ (even \$100,000+)? Do you have a client who is deducting any amount to a benefit program that involves life insurance above and beyond any "vanilla" nominal amounts? Has the Pension consultant told you your client can put in large amounts into benefit programs solely benefitting your client without covering other employees you think normally would be covered under a typical 401(k) Plan? Are you hearing anything that sounds "too good to be true?" Is someone telling you he/she has a benefit program few know about - and that he/she alone in the USA possesses knowledge about big deductions to benefit plans that no one else has?

A YES - to any or all of the above questions should lead you to ask yourself whether further investigation or added "CYAing" is advisable.

REMEMBER - the \$ stakes are huge here!! A client subjected to huge listed transaction penalties is likely to turn into an ugly Plaintiff. And your malpractice policy may or may not cover you for amounts you owe after a Court battle for "listed transactions." You may believe overlooking "listed transactions" is not negligence. But I guarantee you some Courts and Juries will not see it that way. Do you want to "play chicken" with these penalties? Not advised!!

**PART II**

**Everything You Need to Know About Individual  
Retirement Account Prohibited Transaction Rules**

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Contrary to some articles promulgated by IRA promoters the IRC prohibits certain transactions between IRAs and “disqualified persons”. Rules are essentially same as with qualified plans. IRC § 4975. The IRA owner, his/her beneficiaries, the IRA trustee/custodian, etc. are “disqualified persons”. The following are the basic prohibitions:

1. sale or exchange, or leasing, of any property between a plan (IRA) and a disqualified person;
2. lending of money or other extension of credit between a plan (IRA) and a disqualified person;
3. furnishing of goods, service or facilities between a plan (IRA) and a disqualified person;
4. **transfer to, or use by or for the benefit of, a disqualified person, of any assets or income of a plan (IRA);**
5. **an act by a fiduciary whereby the fiduciary deals with the assets or income of a plan (IRA) in the fiduciary’s own interest or for the fiduciary’s own account (i.e., self-dealing); or**
6. **the receipt of consideration by a fiduciary for the fiduciary’s own account from an party dealing with a plan (IRA) in connection with a transaction involving the assets or income of the plan (IRA) (i.e., a kickback).**

An example of a prohibited transaction is the borrowing of money from an IRA by its owner (a rollover of a participant loan from a qualified plan to an IRA also is “borrowing”- see below). Other examples are the sale of property by the IRA owner to the IRA or using the IRA as security for a loan.

See TAM 8849001, ruling that a prohibited transaction takes place when a §401(a) qualified plan participant’s personal note to the plan is distributed in kind and then rolled over into an IRA owned by that individual. Following the rollover, the IRA owner would owe the IRA, constituting a prohibited loan between the IRA and a disqualified person, even though the loan was made before the individual established the IRA.

NOTE - The IRS has determined certain “factoring” or other transactions with an IRA were “listed transactions”. See Regs 1.6011-4(b)(2), 301-6111-2(b)(2) and 301.6112-1(b)(2).

NOTE 2 - I have been presented with several attempts by potential clients asking me to issue an opinion letter to effect that IRA investment in an LLC that does a “deal” with IRA owner is not a “PT”. There is a misconception that use of an LLC obviates PT rules. NOT. A “loan” to an owner - or taking “advantage” of your IRA in an LLC deal (preferred splits) and many proposed co-ownership arrangements still constitutes a PT. There are promoters touting the use of an LLC owned by your IRA (with a cooperating custodian) that allows you, as LLC Manager, to transact business out of view of the custodian. Watch out!

NOTE 3 - There have been rulings or situations where an IRA and the IRA owner can enter into a transaction as “co-owners”, with NO advantage to one or the other, and there was no minimum threshold of \$ for a deal of that type that the IRA owner could not do individually. CAUTION!

NOTE 4 - An IRA’s purchase of leveraged real estate with the IRA owner personally guaranteeing the loan is a PT.

Tax Consequences of PT - If the owner engages in PT with his/her IRA, the entire IRA ceases to qualify as an IRA as of the first day of the taxable year IRC § 408(e)(2). The normal 15% excise tax on PTs does not apply to an IRA unless the person involved in the “PT” is not the IRA’s owner or beneficiary. IRC § 4975 (c)(3) - unclear of this as to an Individual Retirement Annuity. Note - the taxation of the entire IRA is a much worse penalty than the excise tax that applies to a qualified plan. Example - \$1,000,000 IRA. PT involving \$20,000. Entire IRA becomes taxable.

Excise Tax on Entity Manager - A person who causes an IRA to be a party to a “prohibited tax shelter transaction” (IRC § 4965(e)(1)) can be liable for a \$20,000 excise tax.

DOL Opinon Letter 89-3A - (Involves purchase of stock by IRAs. Office/Manager (and his Wife) of a Division of “Rock-Tenn Company” asked to DOL if he could purchase Rock-Tenn stock for their IRAs. They owned a small percentage of R-T stock already, but not anywhere near a controlling interest. Facts:

Rock-Tenn total outstanding shares	= 2,500,000
Amount of shares proposed to be purchased by IRAs	= 400
Amounts Manager and family owned already (or would own if options exercised)	= 28,927
Approximate amount of shares owned by Manager/Family	= 1.2%

DOL concluded R-T was not a “disqualified person” under IRC § 4975(c)(i)(A).

But, DOL declined to rule - saying it was a factual determination that IRC § 4975(c)(1)(D) or (E). DOL told the Manager “you may wish to consider whether the purchases of stock involve violations of IRC § 4975(c)(1)(D) or (E).”

Note - Many practitioners less experienced with the workings of 4975 focus on the percentage (%) tests! But they over look the factual tests of IRC § 4975(c)(1)(D) or (E) that have NO minimum percentages! This is not a mechanical “%” test! And as the penalty can be (if the IRA owner is deemed to engage in a PT with his/her own IRA) taxation of the entire IRA - extreme caution is warranted.

NOTE - Promoters of “checkbook IRAs” whereby you cause IRA to set up an LLC under which the IRA owner is the Manager and is operating “fast and loose” on his/her own without IRA custodial supervision are almost certainly violating two principles of IRA rules:

1. That an IRA custodian is necessary - a qualified financial institution - thereby disqualifying the IRA from status as a “qualified IRA”.

2. That “PTs” are likely to occur in that scenario - with the IRA account owner acting without proper supervision.

New York Times Article October 20, 2007 - Exotic IRAs: Leaving Stock and Bonds Behind (copy on www.BSLLP.com). This article discussed several concepts:

- Music Teacher from Tucson - IRA owns 25 musical instruments and rents to his students (he has an IRA custodian that apparently allows this).

Comment - Income is UBTI. And how these assets are in the possession or control of his IRA custodian is a mystery. And are “musical instruments” “collectibles” (see later tax discussion)?

The article goes on to say ***“In addition, account holders may not personally benefit from their investment in any way other than making legal withdrawals. This means that you may not live in a house you bought with your IRA, or put rental income anywhere but back into the IRA. Finally, any transactions with a lineal family - like children, parents and grandparents - are prohibited. This means a couple cannot invest in a start-up owned by their son.*”**

***When the IRS spots a violation, it shows little mercy, disqualifying the entire IRA, taxing it retroactively and imposing a 10 percent withdrawal penalty on account holders under the age of 59½.***

***Hugh Bromma, chief executive of Entrust, says one client allowed her daughter to live in a condominium owned through her IRA. The government forced the client to liquidate the entire \$750,000 account and charged her over \$1 million in taxes and fines.”***

**PART III**

**Everything You Need to Know About Individual  
Retirement Accounts Except Prohibited Transaction Rules**

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## I. INTRODUCTION AND SCOPE

Not going to go into minute detail - no time, but I will try to hit the big points! In other words the most important thing is to know what is important! There are plenty of resources available to you for greater detail (contact me at [rbutterfield@bsllp.com](mailto:rbutterfield@bsllp.com) if you need greater detail).

## II. IRA ORGINS

Traditional IRA - (ERISA - (1974), SEPs (Revenue Act of 1978), SIMPLE IRAs (Small Business Job Protection Act of 1996), Roth IRAs (Taxpayer Relief Act of 1997), Beneficiary IRAs (Pension Protection Act of 2006).

## III. NOT DISCUSSED

Health Savings Accounts, Coverdell Education Savings Accounts.

## IV. TYPES OF IRAS DISCUSSED

- Traditional IRA - All contributions that were deductible, plus all earnings on deductible and nondeductible contributions, are taxable upon distribution (or perhaps earlier if certain “bad” things happen - see later).
- Roth IRA - No contributions are deductible. All amounts distributed are income tax free if certain qualifications are met.
- SEP - “Employer” level plans in a substitute for a Profit Sharing Plan, etc. involving an employer’s contributions made directly to participant’s qualifying IRA.
- SIMPLE IRA - “401(k) type” Employer level plan in a variation of a deferral program in an employer context.
- Beneficiary IRA (new in 2007) - allows a nonspouse beneficiary of a qualified plan death benefit distribution to directly transfer to a special IRA with payout restrictions.

## V. BASIC PROVISIONS AND REQUIREMENTS FOR ALL IRAS - SEE IRC § 408 AND 408A

\_\_\_\_\_ Written Governing Instrument (Regs § 1.408-2(b)). This instrument, if drafted by the custodian or trustee, is a prototype approved by the IRS before being promulgated to the public (or is under review by the IRS). Or one of several IRS Forms are used such as:

Traditional IRA -An Adoption Agreement combined with trustee/custodian level form:

- Form 5305 (Individual Retirement Trust Account) establishes a trust, under which an individual deposits funds or assets as a settlor with a trustee.
- Form 5305-A (Individual Retirement Custodial Account) establishes a custodial agreement, under which an individual deposits funds or assets with a custodian. The terms of the form are identical to those of the Form 5305 other than the designation of a “custodian” rather than a “trustee”. The only difference in their legal effect, if any, appears to arise under trust or custodianship law of the state in which the IRA is situated.

SIMPLE IRA Form 5304 or 5305 SIMPLE combined with trustee/custodian level form:

- Form 5305-S (SIMPLE Individual Retirement Trust Account) establishes a trust to be used to receive employer contributions under a SIMPLE plan, which are deposited with a trustee (Such an IRA is often called a “SIMPLE IRA”).
- Form 5305-SA (SIMPLE Individual Retirement Custodial Account) establishes a custodial account to be used to receive employer contribution under a SIMPLE plan, which are deposited with a custodian (Such an IRA is often called a “SIMPLE IRA”).

Roth IRA - An Adoption Agreement combined with trustee/custodian level form:

- Form 5305-R, Roth Individual Retirement Trust Account, and Form 5305-RA, Roth Individual Retirement Custodial Account, which serve as IRS - approved model forms for use by financial institutions to establish Roth IRAs for their customers.
- Form 5305-RB, the Roth Individual Annuity Endorsement agreement, which is a model annuity endorsement that meets the requirements of §408A and has been approved by the IRS.

A. U.S. Based (408(a)) - No Hong Kong or Cayman Island based IRAs!

B. No individual trustees (§408(a)(2)) and all assets of the IRA must be titled in name of the custodian. Only Banks or Trust Companies or other eligible financial firms qualify. Sporadic cases where an individual attempts to create his/her “own” IRA always are shot down by the IRS.

C. No Life Insurance. Viatical investments are life insurance - and not allowed in IRAs (contrary to some salespersons’ pitches even assuming it’s a legitimate investment). No rollovers of life insurance policies from Qualified Plans to IRAs.

D. No Discussion of Rules for Individual Retirement Annuities or 408(c) IRA sponsored by an Employer or Union.

VI. CONTRIBUTIONS TO IRAS (IRC§219)

A. Cash Only - except for Rollovers or Direct Transfers.

- No part of a noncash contribution is deductible or treated as nondeductible contribution. Its all treated as an “excess contribution” (with attendant excise taxes).

B. No contributions if 701/2 by 12-31 of year - except for SEPs, SIMPLE, Roth, or a Rollover contribution.

C. Deadline (219(f)(3)) - During calendar year or by April 15<sup>th</sup> (or deadline) without extensions (except for SEPs or SIMPLE matches).

Note - Contributions made in January to April 15<sup>th</sup> period for the prior year must specify in writing to the IRA provider a prior year designation. Default setting is year of contribution.

• Rev. Rule 84-18 - Deduction can be claimed on return filed early as long as the contribution is made by April 15<sup>th</sup> due date.

- PLR 8551065 - Timely mailing suffices.

D. Maximum Per Person Contribution Amounts (Roth and Traditional)

\$4,000 through 2007

\$5,000 2008 >

Age 50+ as of 12/31? Add \$1,000

Note - PPA 2006 (IRC § 219(g)(8)) allows post 2006 inflation adjustments in limits (to the nearest multiple of \$1,000). Does not apply to the \$1,000 “catch up”.

E. Compensation Limit

100% of IRA owner’s “taxable compensation” (special rule for “spousal IRA”)

- Combat pay is included even if nontaxed
- Applied without regard to community property
- Distributions from nonqualified deferred compensation plans - Rev

Proc 91-18

- Taxable alimony counts! 219(f)(1)
- Interest, dividends and capital gains? No!
- Day traders who are in a business?
- S corporation dividends? No.
- Foreign earned income, unemployment compensation, nonqualified

or incentive stock options, SARs - No. PLR 8304088

Special Rule for Spousal IRA - A spouse can contribute to his/her IRA even if his/her compensation is not enough if the spouses file a joint return and the other spouse's compensation is enough to cover contributions to both IRAs.

F. Savers Credit for lower income (extended in recent legislation) IRC § 25B.

Saver's tax credit rates for up to \$2,000 of contributions based on AGI are as follows:

<u>Joint Filers</u>	<u>Head of Household</u>	<u>All other Filers</u>	<u>Credit Rate</u>
\$0 - \$31,000	\$0 - \$23,500	\$0 - \$15,500	50%
\$31,001 - \$34,000	\$23,501 - \$25,500	\$15,501 - \$17,000	20%
\$34,501 - \$52,000	\$25,501 - \$39,000	\$17,001 - \$26,000	10%
Over \$52,000	Over \$39,000	Over \$26,000	0%

Contributions eligible for the credit are reduced by the aggregate distributions received by the individual during the testing period from any entity to which a qualified retirement savings contribution may be made, except for the portion of any distribution which is not includible in gross income by reason of a trustee-to-trustee transfer or a rollover distribution. Thus, contributions that qualify for the credit must be reduced by distributions that are includible in gross income or consist of after-tax contributions. Certain distributions specified in §25B(d)(2)(C) are excepted.

The testing period is the tax year for which the saver's credit is claimed, the two preceding tax years, and the period after the tax year and before the due date, including extensions, for filing the taxpayer's return. Section 25B(d)(2)(D) provides that distributions received by the individual's spouse are treated as received by the individual if the spouse and individual filed a joint return for both the tax year for which the credit is claimed and the tax year the spouse received the distribution.

G. OK, you contributed to a traditional IRA (see later for SEPs, SIMPLE) - Can you deduct it?

Question 1 - Are you or your spouse an "active participant" in the qualified plan (see below)? If no - you can deduct it!

Question 2 - If answer to 1 is yes - see chart below.

Tax Year	Single Active Participant		Married Filing Jointly Active Participant*		Married Filing Separately Active Participant**		Married Jointly Active But Spouse not active (non active spouse can deduct if AGI below \$156,000)
	Low End	to High End	Low End	to High End	Low End	to High End	
	Phase Out ***		Phase Out		Phase Out		
2007	52,000	62,000	83,000	103,000	0	10,000	1 56,000 - 166,000 phase out

\* The active participant reduction for married individuals who file jointly does not automatically apply to the spouse who is not an active participant, unless the couples' AGI exceeds \$156,000 (see chart at right).

\*\* If a married active participant files separately, the reduction applies if the individual's AGI exceeds \$10,000. The spouse of such an individual who is not an active participant is not subject to any deduction reduction, whether or not the spouses have lived apart at all times during the taxable year.

\*\*\* Rounded to next lowest \$10 - with \$200 minimum close to High End.

Note - Adjusted gross income is calculated after application of the Code Sections limiting passive loss limitations and taxing Social Security benefits. In other words, any passive loss deductions that would have reduced the individual's taxable income will be allowed only to a limited degree pursuant to the passive loss limitations, thereby resulting in an adjusted gross income figure that is higher than it would have been had the limitations not applied. Marital status is determined on the last day of each taxable year. With respect to the surviving spouse of a decedent who was an active participant during the taxable year of death, active participation is determined as if the deceased spouse were still alive at the end of the year (Notice 87-16).

Who is an Active Participant?

- Profit Sharing Plan/401(k) Plan - was either allocated a forfeiture during calendar year, deferred compensation to a 401(k) from amounts earned during the calendar year, or was allocated a "PSP" contribution that was made in the calendar year.

Example - ABC, Inc. sets up a new PSP/401(k) for 2007. Mr. ABC defers \$1,000 under a 401(k) deferral to the Plan for 2007- ACTIVE. Mr. ABC defers \$0 for 2007 to the 401(k) Plan but ABC, Inc. makes a contribution for 2007 on March 1, 2008 (and made no PSP contributions in 2007) - NOT ACTIVE.

- Money Purchase Plan- If contribution required to be made for individual for Plan Year ending in calendar year - ACTIVE (does not matter when contribution made).
- Defined Benefit Plan - If benefit accrued during any part of calendar year - ACTIVE.

VII. FEES - Separately billed and paid trustee and/or management fees may be deducted subject to 2% floor of miscellaneous itemized deductions. The management fees must be recurring - not sporadic “commissions” or insurance commissions (see Rev. Rule 86-142).

VIII. TRADITIONAL IRA DISTRIBUTION TAXATION (Amounts not rolled over).

A. Ordinary income (408(d)). No capital gain. Nondeductible contributions give a “basis” considered “investment in the contract.” Per “Campbell v. Comr 108 T.C. 54 (1997) the Tax Court also has said “basis” can occur if a tax-free rollover “failed”, or and IRAs purchases of “collectibles”, or use of an IRA improperly creates taxable income (see later discussion - or earlier discussion of “prohibited transactions”).

Note - 408 (d)(2) aggregates all non-Roth IRAs together in determining “basis”. It is not possible for an IRA owner to designate a distribution as being only from nondeductible contributions. Notice 87-16 Q & A D-2.

Possible “Shakeout” - Rollover all IRA taxable amounts to a qualified plan - leaving behind **non-rollover-able** nondeductible amounts. Then close out IRA (or convert to Roth if eligible).

B. Ordinary Loss - I contribute \$20,000 nondeductible to my only IRA. No other IRAs. Lose \$15,000 in bad deals. Close out all IRAs. \$15,000 loss (subject to 2% floor).

C. Pre 59 ½ penalty - 10% (plus 2 1/2% for California) under IRC § 72 unless one of the following exemptions applies:

- qualified rollover (more than one distribution from the same IRA - or of the same “traced” money - within 12 months from an IRA will adversely affect this as to second and later rollovers).
- death benefits
- Disability as defined in Code 72 (no substantial gainful activity)
- Substantial equal payouts (see elaboration below) - PLRs allow “marshaling” IRAs so as to designate a specific IRA for calcs. Notice 87-16 allows one of several methods to be used, based on life expectancies, but

interest rate now is limited to 120% of the federal mid-term rate. You are allowed under one change before 59 ½ but then you must revert to the “quotient method”. More discussed later.

- qualified first-time home buyer (up to \$10,000 if no house owned within last 2 years). \$10,000 exemption can be used once per lifetime.
- Medical expenses over 7.5% of AGI.
- Health insurance expenses while unemployed.
- Higher education expenses
- Tax levy by IRS under IRC § 6331

D. RMDs - Required Minimum Distribution from Traditional IRAs (§408(a)(6), §401(a)(9)).

- Owner must get distributions by April 1 of year following year attaining age 70 ½ and then by December 31 of that year and each year thereafter. Failure to distribute generates 50% excise tax on the failed distribution amount (§ 4974(a)). Waivers can be requested using Form 5329 if reasonable cause is demonstrated.

- Calculated by dividing IRA balances by the applicable “divisor” specified in Publication 590. Those with spouses more than 10 years younger get benefit of larger divisors. IRA owner can take RMD from any of IRAs. Note - An IRA distribution does not cover the RMD of a qualified plan - or vice versa.

E. Death of IRA Owner before Required Beginning Date (if IRA owner dies after RMD - payment must be “at least as rapid” as method in use at date of death. IRC § 401(a)(9)(B)(i)). - basic choices:

- 5 year rule (applies if there is no beneficiary under the IRA document or no beneficiary form, or if a nonhuman beneficiary exists (charity, estate, etc) - paid in full by end of calendar year including 5<sup>th</sup> anniversary of death.

- Spouse exceptions - Spouse can rollover his/her IRA - but if he/she is under 59 ½, then he can leave it in deceased’s IRA and take without penalty - with no RMD until the deceased would have attained 70 ½. - If spouse is sole beneficiary then he/she can elect to treat the deceased’s IRA as his or her own IRA.

- Payment to designated beneficiary over beneficiary’s life expectancy (with initial life expectancy under IRS Tables reduced for non-spouse beneficiaries by one each year thereafter). If payments begin by 12-31 of calendar year after the calendar year in with the IRA owner dies. If multiple beneficiaries, use shortest life unless IRA broken

into separate beneficiary IRAs by direct transfer (or transferred after 2006 to a new beneficiary IRA) by 9-30 of calendar year after the calendar year in which the IRA owner dies. Life expectancies determined as of that 9-30 (so payout the charity or nonhuman beneficiary by then - and if children have major age differences - divide IRA by then in direct trustee-to-trustee transfers).

- Rollover by direct transfer to one of the new “Beneficiary IRAs” allowed under the Pension Protection Act of 2006 (and the RMD then comes out of it). (IRC § 402(c)(11)(A). Note - This benefits many non-spouse beneficiaries previously forced to take shorter (5 years or less) distributions from company retirement plans.

- no rollovers allowed from parent IRA to child/grandchild IRA or sibling IRA to sibling IRA unless in context of a new “Beneficiary IRA”.

- Designations to a Trust - more complicated-limited discussion in this general outline - see below:

- If Trust is irrevocable at death then possible to pay to trust over shortest life expectancy of trust beneficiary (See Regs).

- If Trust is revocable, such as an “A Trust” in an “A - B Trust” - some Rulings have allowed the surviving spouse to revoke the trust’s beneficiary interest, allocate it to him or her and roll it over. Allowed only if spouse is sole trustee over that decision. (PLRs 200304037, 200130056, 9322005).

NOTE - Designate Trusts only with caution and advice from an estate/benefit planner with appropriate experience. A beneficiary designation to a Q-TIP Trust (to help protect heirs of a prior marriage) can work if done right. A few selected IRA custodians have documents that also will allow a non IRA grantor spouse to designate a “B”/Bypass Trust (or another beneficiary) of his/her community property share of an IRA - a sophisticated technique rarely used but useful at times if needed to “fund the B Trust” to avert wasting estate tax limits.

- IRA documents normally (but do not always) allow the beneficiary to elect (by the life expectancy due date) the RMD method to use. The default election in most IRA documents is the life expectancy rule if no election is made (which means you are violating RMD rules if no election is made - and you wanted to use the 5 year rule).

- Federal estate tax deduction. A beneficiary may be able to claim a deduction for estate tax resulting from distributions from a traditional IRA. The beneficiary can deduct the estate tax paid on any part of a distribution that is income in respect of a decedent. He or she can take the deduction for the tax year the income is reported. IRC § 691(c)

F. Rollovers (Non Taxable Transfers).

1. Direct Transfers between IRA custodians are not rollovers! (But the transfer still needs to be to a qualifying IRA and be a transfer that (except for new post 2007 beneficiary IRAs) could have been eligible for a triangular rollover).

2. Triangular Rollover - IRA #1 to IRA Owner to IRA #2

- 60 day limit (IRS has discretion to waive it in hardship type situations or where Postal or financial institution errors occurred - 408(d)(3)). See Rev. Proc 2003-15 (but waivers will be denied usually if funds were used for short term financing - PLR 20433022).

Note - 60 days applies when in receipt (or constructive receipt) of the check - not the date of the check or date of mailing.

3. No rollovers of RMDs!

4. No rollover allowed of second (or more) distribution from same IRA within any given 12 month period. (Applies separately to each IRA and “follows assets” i.e. cannot rollover same assets to different IRA to allow another rollover within 12 months) IRC § 408(d)(3)(B). Example - of use of 7 IRAs for a “rolling loan”.

5. IRA funds can be rolled to:

- another IRA
- 401(a) Qualified Plan\*
- 403(b) Plan\*

\* Cannot include after tax contributions or nondeductible contributions (but the IRA with nondeductible contributions can be rolled over in full so long as another IRA not rolled over still contains equivalent assets - i.e. the basis “transfers” to the IRA that remains).

NOTE - Under current Bankruptcy law, qualified Plans still have better creditor protection in most contexts than IRAs do -at least in California.- particularly outside of Bankruptcy context. California law gives limited protection to IRAs under California’s Code of Civil Procedure Section 704.115, and current Federal Bankruptcy laws only give “bulletproof” protection from creditors to rollover IRAs (or IRAs from contributions of up to \$1,000,000 in value) in the context of a Bankruptcy.

NOTE - IRA taxable funds can be rolled over to a qualified plan - allowing a participant loan to the participant (50% or \$50,000 if less - subject to all of the stringent plan loan rules and assuming the plan allows loans).

NOTE - special advice beyond scope of this applies to those borne before 1936 who have “conduit” IRAs holding only a qualified plan rollover if 10 year averaging from a later qualified plan is desired.

6. Rollover of in-kind assets from IRA #1 must go to IRA #2. Proceeds of property sold during “second leg of the triangle” cannot be rolled over. However, an in-kind asset in distribution from a qualified plan can be “sold” (to a third party-not simply kept and replaced with other assets) - with proceeds rolled to an IRA (402(c)(6)).

7. Nondeductible after tax contributions to a qualified plan can be rolled or transferred from the qualified plan to an IRA (402(c)).

#### IX ROTH IRAS (tax free withdrawals, without deduction going in).

1. Eligibility - (no active participant rules).

- Contribution - Couples filing jointly \$156,000 - 166,000 phase out, singles - \$99,000 - 114,000 phase out.

- Conversions - Until 2010 - \$100,000 (if not married filing separately - if so then its \$0) AGI (without regard to RMDs). Post 2009 - unlimited - but why would someone in high bracket want to do that? Extremely niche scenarios in spite of financial press’s love of Roths to the contrary. For such rollovers in 2010 the taxpayer will recognize the distribution equally in 2011 and 2012 unless he/she elects to be taxed in 2010. IRC 408A(d)(3)(A).

- Recharacterizations - Reg 1.408A-5 provides rules on “recharacterizing” (non-rollover) contributions to an IRA by the due date of the tax return (including extensions). Thus, a contribution to a Roth IRA can be “recast” as a contribution to a Traditional IRA and vice-versa. Reasons? - Ineligibility for a Roth or a later decision a deductible IRA contribution is preferred. The net income attributable to the recast contribution must be transferred too. You cannot convert and reconvert an amount during the same taxable year or, if later, during the 30-day period following a recharacterization. If you reconvert during either of these periods, it will be a failed conversion. If you convert an amount from a traditional IRA to a Roth IRA and then transfer that amount back to a traditional IRA in a recharacterization in the same year, you may not reconvert that amount from the traditional IRA to a Roth IRA before:

- The beginning of the year following the year in which the amount was converted to a Roth IRA or, if later,

- The end of the 30-day period beginning on the day on which you transfer the amount from the Roth IRA back to a traditional IRA in a recharacterization.

See page 35 of Publication 590 on how to recharacterize a conversion.

Extension. Ordinarily you must choose to recharacterize a contribution by the due date of the return or the due date plus extensions. However, if you miss the deadline, you can still recharacterize a contribution if:

- Your return was timely filed for the year the choice should have been made, and
- You take appropriate corrective action within 6 months from the due date of your return excluding extensions. For returns due April 15, 2006, this period ends on October 15, 2006. When the date for doing any act for tax purposes falls on a Saturday, Sunday, or legal holiday, the due date is delayed until the next business day.

Appropriate corrective action consists of:

- Notifying the trustee(s) of your intent to recharacterize,
- Providing the trustee with all necessary information, and
- Having the trustee transfer the contribution.

Once this is done, you amend the return to show the recharacterization. You have until the regular due date for amending a return to do this. Report the recharacterization on the amended return and write "Filed pursuant to section 301.9100-2" on the return. File the amended return at the same address you filed the original return.

2. Contribution Limits (same as Traditional, but limits coordinate not double up!). Same rounding phase-out and \$200 minimum rules apply.

3. No age 70 ½ limit for Roths (while alive - RMDs apply after death).

4. Rollover to Roth allowed from "Roth 401(k) Account". Pension Protection Act of 2006 allows post 2007 direct rollovers from qualified plans to Roth IRAs, subject to applicable withholding (because its taxable). The rollover directly to a Roth for 2008, and 2009 is allowed only if the taxpayer's AGI does not exceed \$100,000 and is not a married person filing a separate return. IRC § 408A(c)(3)(b). The 10% pre-age 59½ penalty does not apply to this transfer. Note - amounts from a Roth IRA cannot be rolled to a Roth 401(k) Account. Prop Regs 1.408A-10.

5. Conversions can be "undone" by due date of the tax return (even if no extensions were obtained) for the calendar year of the conversion. Example - you decide in 2008 that the tax cost of a conversion was too high or unwise - or your AGI exceeded \$100,000 after all - you have until October 15, 2008 to "undo" the conversion and properly

convert the Roth back to a traditional IRA.

NOTE - seek guidance before doing this after due date of the return if the actual extension did not extend until October 15, 2007.

6. Distributions - (Simplified Version) - TAX FREE if “qualified”:

- After 59 ½ or death
- After disability (72(m)(7))
- Up to \$10,000 per lifetime payout for “1<sup>st</sup> time” (no home owned within last 2 years) home purchase .
- And paid after 5<sup>th</sup> taxable year period beginning with 1<sup>st</sup> tax year a Roth IRA was set up for the taxpayer.

7. No penalty on pre 59 ½ taxable conversions unless amounts are withdrawn from the Roth within 5 years. Note - See 408A(d)(4) for complex “aggregation and ordering rules” that apply if funds are withdrawn from Roth IRA with conversion funds and contributions. With only contributions -no conversions- a Roth IRA is “first in-first out” - principal comes out first.

8. When taking distributions, a Roth IRA owner treats all of his/her Roth IRAs as one Roth IRA. For example, if Rob has a Roth IRA at a Bank, another Roth IRA at a Credit Union, and a third through a mutual fund, Rob will treat them as a single Roth IRA for distribution purposes. [Treasury Regulation Section 1.408A-6, Q 9]. A Roth IRA owner removes Roth IRA contributions and earnings in the following order:

- a. Regular/spousal contributions
- b. Traditional IRA conversion contributions on a first-in, first out basis with taxable amounts before nontaxable (basis) amounts
- c. Earnings on all Roth IRA contributions

Conversion amounts are subject to a 10 % penalty tax if distributed within five years of the year of conversion. If an individual completes conversions in multiple years, each conversion amount has a different five-year period during which a penalty tax may apply. Distributions occur in the order contributed-first in, first out. The penalty tax does not apply if the Roth IRA owner meets an exception to the 10% penalty for early withdrawal.

*Conversion Contributions*

A traditional IRA may contain taxable amounts (deductible contributions, pretax rollovers, and earnings) and nontaxable amounts (nondeductible contributions and after-tax qualified employer plan rollover assets) called basis. Upon distribution from a traditional IRA, the taxable amounts become ordinary income. If an IRA owner has basis, he/she files Internal Revenue Service (IRS) Form 8606, Nondeductible Contributions, with his/her federal income tax return to determine the taxable portion of a traditional IRA distribution, even one converted to a Roth IRA.

## X. SIMPLIFIED EMPLOYEE PENSIONS (SEP)

A. Must be established at Employer level (corporation, partnership, LLC or sole proprietorship). Combination of SEP "Plan" (Form 5305-SEP or a prototype or custom plan) and each participant's own IRA. Form 5305-SEP cannot be used with full confidence if the employer maintains another plan, is in a controlled group, or has leased employees (in that case use a custom or prototype SEP Adoption Agreement).

B. Can be on fiscal year basis (to avert deduction timing problems) if the custom or prototype SEP document allows.

C. Can be adopted and signed after employer's fiscal year ends as long as set up by due date of return (with extensions) - this is not "backdating".

D. Contribution limit is same as PSP-20% of net self-employment income minus ½ of FICA/Medicare - or 25% of W-2 salary, subject to \$45,000 limit for 2007 (\$46,000 for 2008) for 2007 compensation over \$225,000 is excluded (\$230,000 for 2008).

E. Eligibility - 3 calendar years prior to current year (if owner meets it too), more than \$500 compensation in current year, age 21, no minimum 1000 hours.  
Example - Employee "B" age 27 hired on October 1, 2004, works 100 sporadic hours in each of 2004, 2005 and 2006 and makes \$500 in 2007. "B" enters plan on 1-1-2007.

F. Allocations - prorata to pay, with a custom or prototype possibly allowing a small "tie-in" with the Social Security Taxable Wage Base. No "year end employment" requirement is allowed. No minimum hours requirement allowed (just \$500 minimum).

G. Top heavy Minimum Rules do apply based on contribution levels-not account balances (too complex to fully cover here).

H. Investments and Distributions - See rules applicable to IRAs.

I. NO 5500s needed. No fiduciary exposure regarding the "investment side".  
- No restrictions on an employee's ability to withdraw funds.

J. Can allow - for those in low brackets - potentially getting more per year into a Roth IRA (example - you make \$30,000 W-2 per year - no employees - Corp. contributes an additional \$7500 to SEP for 2006 - you convert the \$7500 to a Roth IRA - this "backdoor" increases your Roth IRA contribution by \$3500 and saves FICA Medicare on \$7500 too).

K. Small Employer (under 100 employees) Credit (§45E). If at least one non highly compensated employee is in the SEP, consider §45E's credit of up to 50% of the first \$1000 in administrative expenses for a new plan for the first 3 years. Those expenses used for the credit are not deductible.

Comments - SEPs are diminishing in utility compared to 401(k)s, SIMPLE IRAs, etc. Why? Because of the generous levels of contributions for employees, lack of minimum hours standards, lack of ability to use deferral options, more exotic “age weighted” formulas in 401(k)s and PSPs, and lack of flexibility vis-a-vis owners if multiple owners draw compensation. But they sure come in handy if a post fiscal year end need arises for a new plan (you then set up a different type of plan for year 2). SEPs also can work if an owner wants to, and can get away with, channeling a “bonus” through a SEP, allowing covered employee to withdraw it if cash is needed (although a pre-59½ penalty is a negative-lack of FICA/Medicare is a positive).

Myths - (1) That in a partnership only partners who want to use it need contribute (that is why 401(k) plans or SIMPLE IRAs exist).

(2) Eligibility is based on 3<sup>rd</sup> anniversary of date of hire (it’s a myth) - its based on 3 calendar years out of 5 with some level of work - that’s all.

## XI. SIMPLE RETIREMENT ACCOUNT

A. SIMPLE IRA is a “marriage” of a SIMPLE IRA Account for a participant with a small (under 100 employees) Employer level “plan” (usually the “Plan” is on IRS Form 5304 SIMPLE or 5305-SIMPLE). IRC § 408(p).

- Is not valid unless it’s the only plan of an Employer for the calendar year (Limits flexibility to adopt 401(k) or DB later in year - shut it down as of 12/31/2007 if you think you’ll want to switch plans next year for 2008). Note - The Regulations are vague on how to terminate a SIMPLE IRA, but the FAQs on the IRS website claim notice must have been given before 11-2-07 to terminate a SIMPLE IRA Plan for 2008.

- Must time deductions on a calendar year basis - raises deduction timing issues for calendar year taxpayers - as fiscal year taxpayers deduct contributions for the fiscal year in which calendar year ends.

- No 5500s/no fiduciary responsibility

- Introduces “401(k)” type flexibility with limited options. Deferral allowed under a written advance compensation deferral agreement of up to **\$10,500** for 2007 with an extra **\$2,500** for those age 50+. Mandatory \$1 per \$1 match of 3% (for 2 of 5 years employer can, with proper notice, reduce to 2% or 1%) of pay - with match amount limited to the amount of the deferral (alternative is 2% contribution for all in the plan - even those who do not defer). Note- “Top Heavy” contribution rules do not apply to SIMPLE IRAs. SIMPLE IRAs must be set up by 10-1-2007 to be used for 2007. And the Notice of 2008's contribution method and level must have been distributed by 11-2-07.

- Eligibility - age 21, \$5,000+ in pay during current and each of prior 2 years (maximum-more liberal eligibility can be chosen). That's it - no "carve outs" for eligibility except union or non resident aliens.
- Match contributions can be made up to the employer's tax return due date but elective deferrals from employee's pay must be made within 30 days after the end of the month of deferral.

Note - Under IRC § 408(p)(2)(c) it is possible to set up a SIMPLE IRA program with a 1% match for 2 years then terminate it (with proper notice). The Code Section "deems" the contribution for the prior 3 years to have been 3% (even though the SIMPLE did not exist).

Note - The maximum deferrals and catch-up coordinate with 401(k) deferrals/catch-up.

Example - Business person A age 55 makes \$300,000 W-2 and has 4 employees. Properly established SIMPLE IRA with a 3% match 10-1-07 to defer \$13,000 of his/her December bonus. No other qualified plan accounts or contributions. Calendar year S corporation. His/her maximum 2007 SIMPLE IRA amounts are:

1. Deferral \$10,500
2. Catch up Deferral \$2,500
3. Employer Match \$9,000

Total: \$22,000

B. SIMPLE IRA Account is same as a traditional IRA for all purposes except a 25% penalty applies to any amounts withdrawn from it during the first two years. After that, funds can be transferred/rolled-over to a traditional IRA.

C. Two options - for employers for case of funding:

- Form 5304 - Employees can open SIMPLE IRAs at any institution, and the broker/advisor can charge a "load" or "advisory fee".
- Form 5305 -you designate a single financial institution for location of all SIMPLE IRA accounts to receive the contribution - but the investment must be "no-load" and "no surrender fee."

Comment - Form 5305 is easier on the employer from a contribution view, but will you be able to interest a financial advisor to help your employees?

## XII. INVESTMENT RESTRICTIONS

### A. Unrelated Business Taxable Income (IRC § 512)

The rules related to UBTI relating to rents from real estate or operating

businesses are basically the same for IRAs as for qualified plans (except the UBTI exemption for an ESOP does not apply to an IRA). One exception relates to “unrelated debt financed income” (IRC § 514(a)). An IRA is not sheltered from UBTI to extent income, rents, sale proceeds, etc. relate to the portion of property acquired through use of debt. The exemption under IRC § 514(c) does not apply to IRAs. Thus, normally purchase of leveraged real estate within an IRA (in which appreciation above the interest rate is anticipated) is not advised (see Note below) Other examples of UBTI:

- Income, profits from securities bought on margin
- Gross income from unrelated trades or businesses (i.e., IRA owns an interest in bowling alley directly through LLC).
- Profits from LLC owning real estate that is leveraged-to the extent of the leveraged percentage (try to pay off the loan before selling the IRA’s leveraged real estate).
- Equipment leasing partnerships
- IRA owns a parking lot renting spaces

Form 990-T is due if UBTI exceeds \$1,000. Taxes are paid at trust rates. IRC§511(b)(1).

#### Not UBTI

- Dividends from C corporations
- REIT dividends
- Rents from real estate without a significant personal property component or leverage.
- Interest

Note - An IRA is not a permissible owner of an S corporation.

Note 2 - An IRA is a perfect entity to convert capital gain to ordinary income! Thus, we normally attempt to figure out ways to purchase real estate personally rather than in an IRA, but at times, the only place the client can “swing” the deal is with IRA funds.

Note 3 - Consider rolling/transferring IRA funds to a “zero percent” Money Purchase Plan with just the business owner participating. Why? “Unrelated debt financed income” rules do not apply to a Qualified Plan if there is no seller financing.

#### B. Collectibles

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An IRA’s purchase of a “collectible” is treated as a taxable distribution. IRC §408(m)(1).

A collectible is any work of art, rug or antique, metal (except with respect to certain coins), gem, stamp, coin, alcoholic beverage (e.g., vintage wines), musical instrument,

historical object (such as a document or clothes), or other item of tangible personal property that the IRS determines is a collectible. Gold or silver coins minted by the United States ("American Eagle" bullion coins), or coins issued under the laws of any state are not "collectibles". The IRA owner appears to be able to possess the coins (I do not advise this!), although title to the coins would need to reside in the IRA trustee. Perhaps it is prudent to allow the IRA trustee or custodian to hold the coins, however, in order to avoid an argument that their possession by the IRA owner is a prohibited "use" of the IRA's assets (constituting a prohibited transaction). Platinum coins minted by the United States ("American Eagle" bullion coins) or any gold, silver, platinum, or palladium bullion of a fineness at least equal to the minimum fineness that a contract market requires metals used to satisfy a futures contract, also is exempt, but the bullion must be in the physical possession of an IRA trustee or custodian (not the IRA owner).

### XIII. REPORTS, DISCLOSURE, WITHHOLDING

A. Deductible contributions - Report on Form 1040

B. NonDeductible contributions - Form 8606 (needs to be filed to report nondeductible contributions even if 1040 is not due).

C. Form 5329 filed with 1040 when:

1. Excise taxes due on contributions (6% per year excise tax on over-contributions to an IRA)
2. Pre-age 59½ distributions
3. Failure to receive RMD

D. Form 1099-R - Distributions (comes from IRA custodian). Form 5498 also comes from the IRA custodian.

E. Income Tax Withholding. Federal income tax and California tax withholding from an IRA but the recipient may elect out of withholding is mandatory on all distributions for any reason. IRC § 3405.

Note - Withholding from an IRA is considered to be paid over the full year. Example - taxpayer realized in December she failed to pay sufficient quarterly estimates. Withhold 100% of an IRA distribution and send to IRS. If under 59½, or you want to avert taxation, rollover the amount to an IRA within 60 days from other sources.

### XIV. TRANSFERS INCIDENT TO DIVORCE

A direct transfer of a portion of an IRA to an ex-spouse under a divorce order or marital settlement agreement in connection with a divorce is nontaxable to either spouse. IRC § 408(d)(6). The new IRA set up for the ex-spouse then becomes his/her IRA for tax purposes.

NOTE - Simply removing funds from an IRA to pay an ex-spouse does not transfer tax liability (I have a client finding this out the hard way). The only way to transfer the tax liability is with a bonafide court order under a divorce judgment.

NOTE 2 - It is a myth that the exemption under a QDRO for the pre-age 59½ penalty applies to IRAs. IRC § 72(t)(2)(c)'s exemption applies only to distributions to "Alternate Payees" (ex-spouses) from a Qualified Plan.

Example - Age 40 ex-spouse gets \$100,000 from 401(k) Plan and keeps it. No penalty. He/she instead transfers directly to an IRA and then takes \$20,000 per year. Penalty. Participant with \$100,000 traditional IRA transfers it to 401(k). Then arranges a QDRO to pay it to ex-spouse. This potentially allows the ex-spouse a penalty free withdrawal over 5 years that he/she could not have received directly from the IRA.

#### XV. 6% EXCISE TAX IRC § 4973

\_\_\_\_\_ What if you or your age 40 client contributes \$18,000 to an IRA instead of \$4,000? Or what if he/she transfers a \$100,000 rollover from a "disqualified" Profit Sharing Plan to an IRA and the IRS later successfully claims was a taxable transfer? All amounts in excess of the properly contributed or rollover amount are "Excess Contributions". IRC § 4973 imposes a per year excise tax of 6% of the amount of the "excess". The "excess" is calculated under IRC § 4973 (as modified by distributions by the due date of the return allowed under IRC § 408(d)(5)).

Comment - The excise tax is 6% per year. So-if the IRS audits 3-4 years after the affected year, the non-deductible tax can prove significant indeed ( and it is on top of otherwise applicable taxes, interest, penalties and pre-age 59½ penalties).

NOTE - When rolling/transferring a distribution from a "doubtful" Qualified Plan (doubtful being a plan where its qualification is not absolutely certain) consider creating a recipient Qualified Plan - possibly a "zero % Money Purchase Pension Plan covering just the owner". Why? Because at worst case, the distribution is taxable, but the "excess contributions" tax of 4973 is not a factor.

#### XVI. ADDED PENSION PROTECTION ACT OF 2006 FEATURES.

A. No 10% early withdrawal penalty for Reservists. IRC § 72(t)(2)(G).

PPA 2006 allowed penalty free withdrawals from an IRA or elective deferrals in 401(k), 403(b), etc. to a reservist called to active duty in excess of 179 days (or indefinite period) that is made on or after call to duty and before end of active duty. Effective - September 11, 2001. Refunds could have been claimed for "closed years" until August 16, 2007.

B. 2007 Charitable Distributions from IRAs of 70½+ Owners. IRC § 408(d)(8).

PPA 2006 allows up to \$100,000 for 2007 directly to a 501(c)(3) qualifying charity (see below) from an IRA (only IRAs-not qualified plans)

- No reportable income
- No impact on AMT
- No AGI limits
- Non-itemizers can use it to make any IRA transfer to a charity in 2007 tax free.
- Distribution does count for post 70½ required minimums.
- “Haircut” rule avoided.

NOTE - “Donor advised funds” (IRC § 4966(d)(2)) - supporting organizations described in IRC § 509(a)(3) do not qualify.

NOTE 2 - The entire amount of the gift must be otherwise deductible to qualify. In other words no using of this IRA technique to provide funds to attend charity dinners, bids on silent or live auction items, or “charitable travel expeditions”.

NOTE 3 - Distributions not allowed to fund a charitable remainder trust or gift annuity.

NOTE 4 - A direct transfer from a qualified plan to an IRA must occur first if your client has no IRA funds to do this with. Only IRA transfers qualify.

NOTE 5 - The Code Section has a special ordering rule treating non-deductible contributions as coming out last (thus no loss of any tax free nondeductible IRA contributions when doing this).

C. IR-2006-125. IRS reminded military veterans that tax-free combat pay can count in determining eligibility for an IRA. They have until 5-28-2009 retroactively make contributions for 2004 or 2005.

XVII. OTHER MISCELLANEOUS ITEMS TO KEEP IN MIND IN 2007.

A. All Defined Contribution Plans and Defined Benefit Plans need amending for EGTRRA and other laws and regulations under a 5 year cycle - (cycles begin to end in 2007! See below:

Over the past four years the Internal Revenue Service and the Department of Labor have issued regulations that affect a Qualified Plan. Laws enacted in 2001 (EGTRRA) also mandate a series of amendments to bring the Plan into compliance. The IRS implemented a staggered deadline to bring qualified plans into compliance based upon the **last digit of**

the plan sponsor's federal employer identification number (EIN).

**All qualified plans must be amended to comply with the new regulations to maintain the plans' tax-qualified status.** The compliance periods are as follows:

(See the last paragraph below for extended periods for Volume Submitter Plans)

<b>Last Digit of Plan Sponsor's EIN</b>	<b>Cycle</b>	<b>EGTRRA Remedial Amendment Period Ends</b>
1 or 6	A	January 31, 2007
2 or 7	B	January 31, 2008
3 or 8	C	January 31, 2009
4 or 9	D	January 31, 2010
5 or 0	E	January 31, 2011

The amendment to the Plan is mandatory. Plans using Volume Submitter documents that adopt a special IRS Certification have extensions of the deadlines. The extension generally is a year or more after the approval of the basic Volume Submitter document by the IRS - which means plans with EINs ending in 1, 2, 6 and 7 will most likely not need to be amended until after the due date shown above.

Plans which fall under Cycle A (last digit of plan sponsor EIN ending in 1 or 6) needed to adopt a Certification of Intent to amend on an IRS approved Volume Submitter plan document **by January 31, 2007**. This Certification on IRS Form 8905 significantly extends the compliance period.

NOTE - ESOPs, Non prototypes or Non Volume Submitter documents need to pay close attention to the above to avert missing a deadline to amend for EGTRRA, etc. And Volume Submitter plans with a January 31, 2007 deadline needed to sign Form 8905 on or before January 31, 2007.

### XIII. SAMPLE FORMS FOR ILLUSTRATION.

- A. Form 5305 - SEP
- B. Form 5304 - SIMPLE
- C. Form 5305 - SIMPLE