THE Pension Digest

Published Since 1984 Collin W. Fritz & Associates, Inc., *"The Pension Specialists"* March, 1990

More business customers are inquiring about SEPs (Simplified Employee Pensions) this year than ever before. For that reason, any financial institution which presently does not accept SEP contributions should seriously rethink its position. April 16th, 1990 is the deadline (unless a filing extension is in effect) for a self-employed individual with a calendar year tax year to establish and/or fund a SEP.

SEPs are simple. But too often, banks and their personnel conclude that SEPs are very similar to Keoghs and so must be inherently very complicated. That is just not the case. Very substantial deposits may arise from SEPs without great complexity.

What is a SEP?

A simplified employee pension (SEP) is a written arrangement that allows an employer (including a self-employed individual) to make retirement contributions on behalf of its employees, or–in the case of a self-employed individual–on behalf of him or herself.

Why are SEPs so Attractive?

SEPs are desired by business customers because they permit larger contributions than regular IRAs. The limit is the lesser of 15% of compensation or $30,000 per employee. An exception is the special adjustment that must be made for a self-employed individual. The formula to calculate the maximum deductible contribution for a self-employed individual is income/1.15 x 15 = the allowable contribution. For example, a self-employed individual with net earnings of $115,000 could contribute and deduct $15,000 with a SEP (i.e. 13.043%). The maximum IRA contribution on the other hand, is $2,000, making SEPs a very desirable option.

The SEP written arrangement is the combination of a SEP plan document and an IRA for each eligible employee. The business customer is responsible for establishing the SEP, but may need help in obtaining the SEP plan document. The customer will look to either their accountant/tax advisor for the plan document, or to the bank. The bank may, but is not required, to assist the customer in meeting the SEP plan document requirement.

Here's Why You Should . . .

There are three ways to meet the SEP Plan Document requirement: (1) use IRS Model Form 5305-SEP as revised in June of 1988; (2) use a SEP Prototype or (3) use an individually designed SEP plan.

This article is limited to discussing the use of Form 5305-SEP as the plan document.

A bank or savings and loan should, at minimum, have available IRS Model Form 5305-SEP. This form may be obtained at no charge from the IRS, or at a nominal fee from most forms vendors, such as Collin W. Fritz and Associates.

A sample of Form 5305-SEP is enclosed. The actual plan document form is very short and very easy to complete.

Responsibility for Accuracy

Financial institutions should note that the customer has responsibility for accuracy. If customer uncertainty exists, consultation with his or her tax advisor may be warranted.

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An Opportunity for Service

Although the customer bears ultimate responsibility for completing these forms, it's relatively easy for a financial institution to provide basic assistance, and therefore reap the benefits of maintaining their SEP account.

Filling out the form is easy. Just:

1. Fill out the name of the business (blank #1).

2. Define minimum age for plan participation (blank #2). This is usually 21, or could be N/A (not applicable) if a one-person business.

3. Set years-of-service requirement (blank #3). This is commonly 3 years. But remember that for new businesses a contribution can't be made until the requirement is met. N/A may also apply here.

4. Indicate if the plan will include union employees (blank #4). Most will not.

5. Indicate if the plan will include employees earning less than $300 for the current year (blank #5). Most will not.

Don't Miss a Major Deposit

Few plans are simpler to open. But without a SEP plan available to customers, an IRA/custodian cannot accept deposits in excess of $2,000, unless the contribution is a rollover. A signed copy of Form 5305-SEP is sufficient verification to accept such a contribution.

Although many businesses can use IRS Form 5305-SEP, certain employers cannot, including the following:

1. An employer who currently maintains any other retirement plan. Note that this restriction prevents an employer who has a QP/Keogh plan from using the IRS Model Form 5305-SEP as the SEP plan document. A SEP prototype, however, could be used. This restriction does not apply if there are two different employers.

Example: If a person working for John Deere, Inc. participates in its profit sharing plan, and this person also farms, then he or she may establish a SEP for their farm income. As an employer this person only has one plan—the SEP. As an employee he/she participates in another plan. This participation does not disqualify use of the IRS 5305-SEP form.

2. An employer who now or who has ever maintained a defined benefit plan. *Continued on Page 3*

Distribution Code Changes—Correction; Further Commentary

The January issue of The Pension Digest discussed overall changes in the codes used to identify distributions on the Forms W-2P and 1099-R. Some additional comments on the codes used to identify rollovers are appropriate here.

As of the 1989 tax year, code 2 applied to rollover contributions. For 1990, Code 2 DOES NOT apply to rollovers. (Table A on page 2 of the January Pension Digest indicated that both 1989 and 1990 codes for rollovers were Code 2. This was incorrect, in light of a new interpretation recently issued by the IRS.) Table A as originally shown and as corrected are set forth at right:

For the 1990 tax year, rollovers are to be recorded either as Code 1 (premature distribution) when made before age 59-1/2, or Code 7 (normal distribution) when made after age 59-1/2.

The fact that a Code 1 rollover is termed a "premature distribution" may initially seem alarming to an IRA accountholder. The IRS for auditing purposes has decided the first audit step is to compare what is reflected on the individual's 1040 (lines 16a and 17a show gross amounts received from an IRA and QP plan respectively and lines 16b and 17b reflect the taxable portion) versus what shows up in Box 2 of Form 5498. The second step in any auditing procedure would be to determine if the rollover was in fact done correctly.

If the entire distribution is validly rolled over then none of the amount distributed is taxable.

In summary, the IRS finally concluded that the rollover code on Forms W-2P and 1099-R was not furnishing them with data that meant anything. An individual may have believed he or she would roll over a particular distribution, but the information which the IRS wants is that which indicates IF the rollover actually took place, and for what amount. Thus, the bank no longer has any responsibility with rollover distributions. The customer/taxpayer will have to explain to the IRS that a distribution was rolled over.

You should prepare yourself and your personnel to explain these new reporting rules to your customers because some are going to have a hard time understanding

Table "A"

Originally

Type of Distribution	1989 Code	1990 Code
— Rollover	2	2
— Disability	3	3
— Death	4	4
— Premature - No Known Exception	1	1
— Premature, Exception Applies	1	2
— Substantially Equal Periodic Payment Exception Applies	1	2

Table "A"

As Corrected

Type of Distribution	1989 Code	1990 Code
— Rollover	2	1 or 7
— Disability	3	3
— Death	4	4
— Premature - No Known Exception	1	1
— Premature, Exception Applies	1	2
— Substantially Equal Periodic Payment Exception Applies	1	2

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3. An employer who is part of a controlled group, an affiliated service group or who uses leased employees.

A SEP prototype can be used to accomplish most of what the Form 5305-SEP cannot do. The special value and availability of SEP prototypes will be discussed in next month's newsletter.

Social Security Benefits' Effect on IRA Deductibility

As is well known, an individual who is an active participant in another retirement plan must apply a special formula based on adjusted gross income to determine what portion of an IRA contribution is deductible.

Likewise, an individual who is receiving social security payments must include in his or her gross income an amount equal to the lesser of: (1) 50% of the benefits or (2) 50% of the amount by which the individual's gross income exceeds a certain base amount. The base amount is $25,000 for single taxpayers, $32,000 for married individuals filing jointly, and $0 if married individuals file separately.

What happens for income tax purposes if an individual receives social security payments, which must be included in income, and also wants to make a deductible IRA contribution? How are the calculations made?

Note that both calculations depend on the use of gross income. A deductible IRA contribution will reduce an individual's gross income for social security purposes. On the other hand, if social security benefits are taxable and thus increase one's gross income, then this will result in the individual qualifying for a lesser IRA deduction.

IRS Publication 590 tells an individual who has both the IRA and the social security situation what needs to be done. But the instructions for Form 1040 do not. On page 13 of the 1040 instructions, the following caution is provided:

"Caution: if you made IRA contributions for 1989 and you were covered by a retirement plan at work, you may need to make a special computation. Get Pub. 590 for details."

The IRS has come up with a three step approach in Publication 590 (i.e three worksheets) to assist an individual in this situation.

Step 1 (Worksheet 1) is to calculate the modified adjusted gross income (AGI) for IRA purposes.

Step 2 (Worksheet 2) is to calculate the maximum IRA contribution amount which qualifies to be deducted.

Step 3 (Worksheet 3) is to calculate the portion of the social security benefits which will be taxable.

In summary, those individuals who receive taxable social security benefits and who are active participants for IRA purposes, must make complex calculations to determine what their permissible IRA deduction is, and how much of their social security benefits will be taxable.

Deductibility and Taxability of IRA Fees

When may an IRA accountholder pay "IRA fees" with non-IRA money and yet be able to deduct the payment as a miscellaneous expense?

Will an IRA accountholder be taxed for a distribution when his or her self-directed IRA pays an "IRA fee"?

These are two similar yet different questions which arise fairly often. The IRS position with respect to both questions is settled.

1989 IRS Publication 590 contains the following statements on the deductibility of broker's and trustee's fees paid with non-IRA funds:

Broker's Commissions

Broker's commissions that are paid by you for your IRA are subject to the contribution limitation and are not deductible as a miscellaneous deduction on Schedule A (Form 1040).

Trustee's Fees

Trustee's administrative fees, which are billed separately and paid by you in connection with your IRA, are deductible (to the extent they are ordinary and necessary) as a miscellaneous deduction on Schedule A (Form 1040), and are subject to the 2% adjusted gross income limit. These fees will not be subject to the contribution limit. The authority for this statement is Rev. Ruling 84-146.

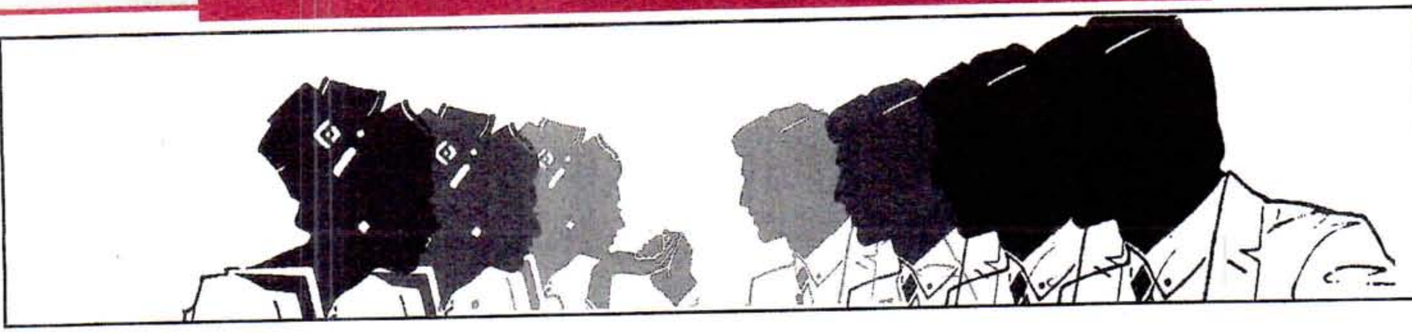
The following example illustrates the IRS position. Kathy Kennedy contributes $2,000 to her self-directed IRA on July 8, 1989. On December 30, 1989 the broker prepares its invoice for $85 for the transactions it has carried out in 1989. If the IRA pays the fee, obviously Kathy is not entitled to deduct this payment as a miscellaneous deduction since the IRA paid the fee and not her. However, if she elects to pay the $85 herself, the IRS position is that this payment constitutes a contribution of $85 to the IRA and the IRA is then deemed to have made the payment. Since she has contributed $2,085, she has an excess contribution.

In contrast, if there had been a trustee fee for administrative services of $75 and Kathy had paid this fee from her own personal funds, then this payment of $75 would not be considered to be an additional contribution and it would be deductible as a miscellaneous expense subject to the 2% limitation.

The determination of whether a particular fee is a trustee fee or a broker fee is not always an easy one to make. IRA trustees must tread carefully if they try to convert all broker fees into trustee fees. The IRS would view such actions as suspect.

The IRS has also dealt very recently with the question, "Would an IRA accountholder be subject to taxation because their IRA paid the trustee fees?" The IRS has said "no" to this question in a recent Private Letter Ruling 8951010.

The general rule of Code section 408(d)(l) is that the person who receives an IRA distribution will be taxed. But no distribution occurs when the IRA pays the fees.



Divorce and the Disposition of Retirement Funds

When a marriage ends in divorce, more than just physical assets, offspring and bank accounts are divided between husband and wife. Although they represent resources intended for future use upon retirement, IRAs and interests in pension plans do not escape the settlement decree.

While the regulations within the Internal Revenue Code do not generally permit transfer of IRA or pension fund ownership without co-distribution, and taxation of the original owner, there are two notable exceptions; death and—the focus of this article—divorce.

IRA Transfers

The Internal Revenue Code allows the transfer of funds from one spouse's IRA to the other's IRA, if so ordered by a court's property settlement or divorce decree. Since this procedure merely moves funds from one account to another, and does not directly distribute funds to a spouse, this transaction need not be reported to the IRS.

Prior to making such a transfer, a financial institution is well advised to request a copy of the decree or settlement, and to have both parties sign a letter or agreement consenting to the transfer as per the decree/order. Date and case number of the decree/order should be recorded. All that then remains is to complete a transfer request form, and make the actual transfer.

IRA Rollovers

When a financial institution accepts rollover dollars from another type of pension plan to a recipient spouse's IRA, that is a very different matter. This transaction IS reported to the IRS, and ***must meet certain qualifications***.

Specifically, this can only be done when the divorce proceeding includes a Qualified Domestic Relations Order, known as a QDRO. In addition to the many provisions concerning property and privileges that are common to most divorce settlements, such an Order must be made pursuant to a ***state domestic relations law***, and also meet the following criteria:

• It must create or recognize the existence of an alternate payee's right to, or assign to an alternate payee the right to receive all or a portion of the benefits payable with respect to a participant under a pension plan, and

It clearly specifies:

• The name and last known mailing address of the participant and the name and mailing address of each alternate payee to which the order relates;

• The amount or percentage of the participant's benefits to be paid to the alternate payee or the manner in which the amount is to be determined; and

• The number of payments or period for which payments are required.

It must not:

• Require a plan to provide any type or form of benefit, or any option not otherwise provided under the plan;

• Require the plan to provide increased benefits, or

• Require payment of benefits to an alternate payee that are required to be paid to another alternate payee under a previously existing QDRO.

Additional Considerations

When a pension plan participant with a vested account balance is required by divorce decree to pay all or part of his/her vested interest to a spouse, that spouse becomes the "alternate payee."

For a qualifying rollover to be made, the distribution of these funds ***must be made pursuant to a QDRO, must include*** the ***entire balance*** due the recipient spouse, and ***must be paid*** to the alternate payee ***within one tax year***. As with other rollovers handled by a financial institution, the rollover must be made within 60 days of receipt, and the "same property rule" applies.

(***Note: Distributions from a 403(b) annuity may not be rolled over as a QDRO distribution.)

QDRO Rollover Procedure

The complexity in QDROs pursuant to a divorce lies primarily in the legal sphere; much less so in the area of bank responsibility—an important difference.

The bank trustee handles the rollover just like any other rollover contribution. In this case the depositing (recipient) spouse must complete a Rollover Certification indicating that the funds qualify for rollover treatment. If possible, also have the spouse furnish a written statement from the plan administrator indicating that the funds qualify to be rolled over. Box 2 of Form 5498 is then completed to reflect the rollover contribution. PD

Tax Filing Deadline April 16

Because April 15 falls on Sunday this year, the normal tax return filing deadline shifts to April 16.

Returns for the 1989 tax year—or Form 4868, Application for Automatic Extension of Time to File U.S. Individual Income Tax Return—must be postmarked no later than April 16.

While Form 4868 extends the time for filing, it *DOES NOT EXTEND* the *TIME FOR PAYMENT*, or preclude penalties for late payment if money is due the Federal government. PD