THE Pension Digest

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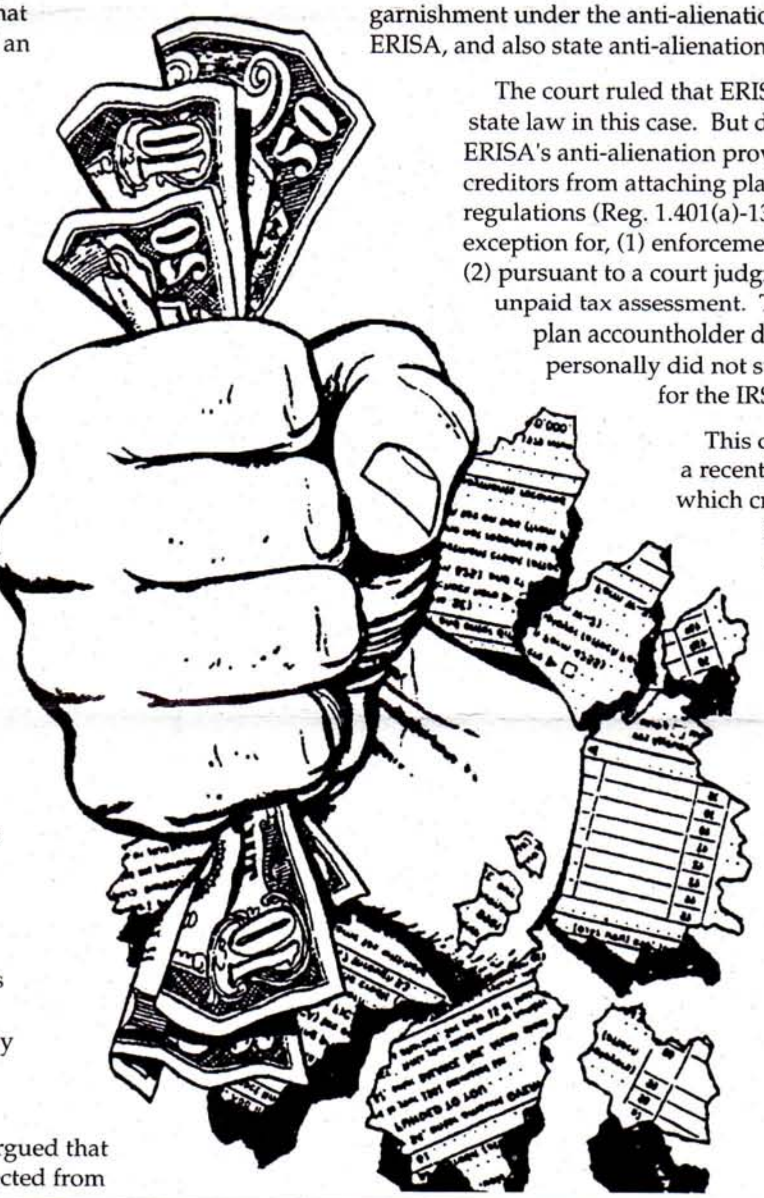
"Long Arm of IRS" Seizes Third Party's Keogh Assets to Pay Second Party's Taxes



It has long been recognized that the IRS can seize or levy against an individual's Keogh plan assets to satisfy an unpaid tax obligation. But recently the IRS broke new legal ground by seizing a third party's Keogh assets to satisfy another's tax debt.

The case of USA v. Morris Weintraub was heard in U.S. District Court, Southern District of Ohio, and a ruling issued in March of 1990. In this case, a Keogh plan participant owed a large sum of money to another individual who had unpaid Federal taxes. The IRS filed suit and obtained a judgment against the plan participant, and successfully filed a motion to garnish the Keogh account.

The basis for this judgment is IRS Code section 6332. This section states that a levy upon a taxpayer's property—held by a third party—is permissible to satisfy a Federal tax debt. In this case, the "taxpayer's property" was interpreted to include money owed to him by the Keogh plan participant (the "third party").

The Keogh plan participant argued that Keogh account assets were protected from garnishment under the anti-alienation provisions of ERISA, and also state anti-alienation law.

The court ruled that ERISA did in fact pre-empt state law in this case. But despite the fact that ERISA's anti-alienation provisions generally prohibit creditors from attaching plan assets, it noted that IRS regulations (Reg. 1.401(a)-13(b)(2)) provide an exception for, (1) enforcement of a Federal tax levy, or (2) pursuant to a court judgment resulting from an unpaid tax assessment. The fact that the Keogh plan accountholder did not owe the taxes personally did not sway the court from ruling for the IRS.

This case is just one example of a recent flurry of litigation in which creditors—not just the IRS—are attempting to seize either qualified plan or IRA assets to satisfy judgments. The usual defense is to cite ERISA's anti-alienation provisions. However, decisions being handed down by the courts are split on the legality of seizing retirement plan assets to satisfy creditors. There currently seems to be no clear consensus on this important issue. PD

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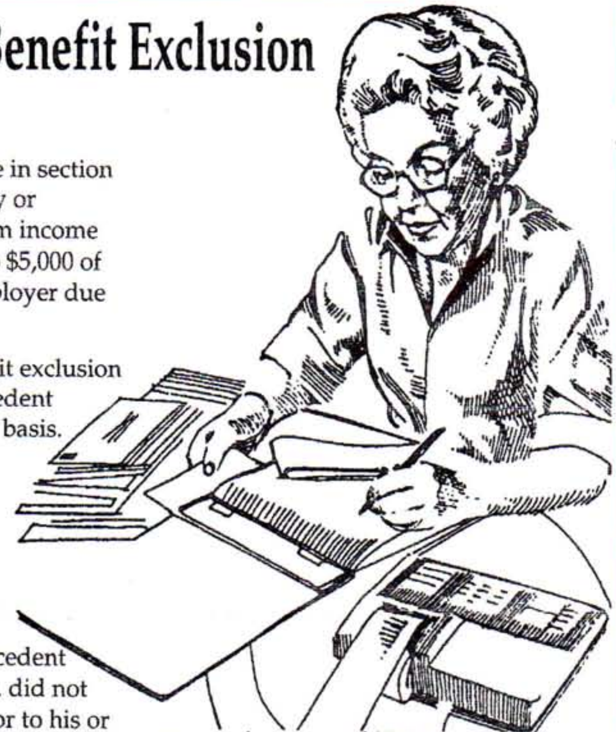
A Primer on the QP/Keogh $5,000 Death Benefit Exclusion



Because Qualified Plans or Keoghs seem to be much more complicated than IRAs, some bank personnel attempt to influence their customers to move funds from a Keogh to an IRA or SEP-IRA. However, such action is not necessarily in the customer's best interest.

There are two primary reasons for a QP/Keogh accountholder who has not yet begun to take age 70-1/2 Required Minimum Distributions (RMDs) to keep the QP/Keogh rather than convert funds to an IRA via a rollover.

These reasons are: (1) the benefits of the $5,000 death benefit exclusion, and (2) favorable capital gains and/or 5/10 year averaging treatment. (Greatly simplified, 5/10 year averaging allows a beneficiary to receive a lump sum distribution, while paying income tax on it as though it were spread out over five or ten years.)

Since past Pension Digests have discussed the capital gains and 5/10 year averaging advantages, we will focus here on the $5,000 death benefit exclusion. In its simplest terms, this provision may allow a QP/Keogh participant's beneficiary to receive up to $5,000 tax-free, upon lump-sum distribution following the accountholder's death. This can be a substantial tax advantage. This applies regardless of whether or not the QP/Keogh participant has begun required 70-1/2 minimum distributions.

"... the death benefit exclusion can provide a substantial tax advantage, regardless of whether the ... participant has started required minimum distributions."

But if the accountholder decides, or is persuaded, to convert their QP/Keogh to an IRA, the advantages of the $5,000 death benefit exclusion are lost. In effect, this results in making $5,000 of non-taxable funds – taxable.

Whenever possible, the $5,000 death benefit exclusion should be saved for the QP/Keogh's beneficiaries (while incidentally also protecting the 5/10 year averaging option), by not converting such funds to an IRA.

Some General Rules

The Internal Revenue Code in section 101 provides that a beneficiary or beneficiaries may exclude from income (and therefore taxation!) up to $5,000 of funds paid to them by an employer due to an employee's death.

The maximum death benefit exclusion of $5,000 applies on a per decedent basis, not on a per beneficiary basis. When there is more than one beneficiary, the exclusion amount must be allocated among the beneficiaries.

The general rule is that the death benefit exclusion only applies to funds which the decedent was not entitled to receive (i.e. did not own or was not vested in) prior to his or her death. The purpose of the law is to encourage employers to give the beneficiary additional monies on account of the employee's death. The death benefit exclusion may apply to funds paid from pension and profit sharing plans, and any other payment from an employer due to the employee's death, such as an insurance settlement.

Thus, that portion of a pension account balance which was not vested prior to death, will qualify for the exclusion.

A special rule (i.e. an exception to the general rule) provides that vested funds (i.e. owned by the participant) will also qualify for the death benefit exclusion IF they are distributed in the form of a lump sum distribution. This special death benefit exclusion was not always available to one person QP/Keogh plans and other plans covering the self-employed. It became available to all self-employed participants after December 31, 1983.

Lump Sum Tax Options

What tax options does a beneficiary have when a lump sum distribution is made after the Keogh accountholder's death? If the beneficiary is the spouse of the decedent, he or she has three options. Let's assume that Janis Peters dies with $30,000 in her QP/Keogh plan. Her husband, Henry, is the sole beneficiary.

First, he may roll over $25,000 to an IRA (i.e. those funds to which the death benefit exclusion does not apply—the amount in excess of $5,000). Such a rollover can be made to an IRA but not to another qualified plan. Thus, he cannot roll over the entire $30,000. A beneficiary does not elect whether he or she wants the exclusion to apply. It automatically applies. Any amount which qualifies to be excluded from income would constitute an excess contribution if it were rolled over to an IRA. The 1989 IRS Publication 575 quite clearly says, "You cannot roll over into an IRA any part of the distribution that qualifies for this exclusion."

Second, he may 5/10 year average the $25,000, which—again—is the amount to which the death benefit exclusion does not apply.

Third, he or she can keep $5,000 tax-free, roll over some portion of the $25,000, and pay ordinary income tax on the remainder. Even if the beneficiary is under age 59-1/2, the 10% penalty tax will not apply, since payments on account of death are not subject to this penalty.

If the beneficiary is NOT the spouse of the decedent, he or she basically has just one option when the payment is received in lump sum format—apply the $5,000 death benefit exclusion, and 5/10 year average the remainder.

Form 1099-R Reporting of the Death Benefit Exclusion

How are boxes 1, 2, and 7 of the 1990 Form 1099-R to be completed to reflect

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that fact that the $5,000 death benefit exclusion applies? The instructions are not as clear as we would like them to be, but we conclude the following:

In box 1 (gross amount), the total amount of the distribution is inserted. Using the example of the $30,000 account balance above, you would insert $30,000.

In box 2 (taxable amount), the taxable amount of the distribution is inserted. This amount would be $25,000 (as in the example above).

The reason code(s) for the distribution are inserted in Box 7. Two reason codes will need to be used for lump sum payments from a qualified plan to a beneficiary. The numerical code 4 (death) is used along with the applicable alpha code: A – qualifies for 5/year/10 year averaging; B – qualifies for the death benefit exclusion, or C – qualifies for both A and B.

In summary, the $5,000 death benefit exclusion is a valuable tax planning device that should not unknowingly be forfeited. Most customers will wish to keep their QP/Keogh rather than moving its funds to an IRA if they understand the $5,000 death benefit exclusion rules. This is true even if the QP/Keogh customer has started his or her required "70-1/2" minimum distributions. Keep these facts in mind when advising your QP/Keogh accountholders.

Prototype Filing Deadline August 13

The May issue of The Pension Digest indicated that the IRS had not yet set the filing deadline for master and prototype plans, including regional prototypes. Immediately thereafter the IRS set a deadline of August 13, 1990—90 days following the publishing of proposed regulations under IRS Code section 401(a)(4) in the Federal Register, which occurred on May 14.

Clarification on 401(k) Article

In last month's issue it was stated that "Another selling point of the 401(k) is the participant's ability to receive (free of IRS penalty) pre-retirement age distributions in the form of either hardship withdrawals or hardship loans." This statement was too broad. It is true that loans on account of hardship do not result in income taxation unless a default occurs. However, withdrawals prior to age 59-1/2 will be subject to the special 10% excise tax of Code section 72(t) unless one of the listed exceptions applies. Hardship is not one of those exceptions.

IRS Favorable Opinion Letters Delayed; All Mass Submitters Affected

The IRS' "favorable opinion letters"—which provide assurance to organizations that their qualified plan prototypes meet Code regulations—have been delayed, according to word received recently from an IRS staff member.

The IRS is said to be having difficulty with their computer program for processing plans submitted on disks. This is the case for all mass submitters, rather than an isolated problem, CWF has been told.

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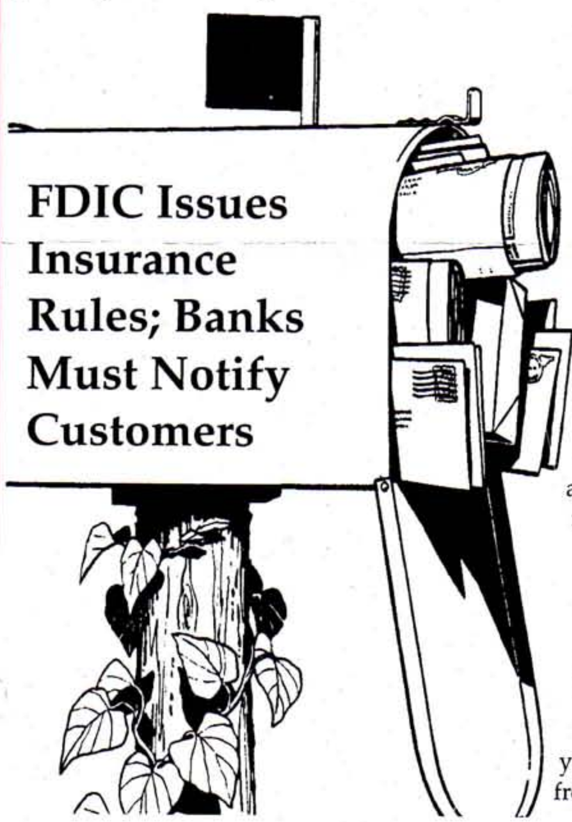
On April 30th the Federal Deposit Insurance Corporation (FDIC) issued revised rules on deposit insurance coverage, affecting accountholders of both banks and savings and loans. The new rules are primarily aimed at bringing uniformity to the (formerly) two insuring bodies, the FDIC and the now defunct Federal Savings & Loan Insurance Corporation (FSLIC).



FDIC Issues Insurance Rules; Banks Must Notify Customers

". . . each institution must provide their accountholders an official Notice . . . by July 29, 1990."

Although most accountholders will not be immediately affected by the coverage changes, all financial institutions ARE affected. According to the April 30th announcement, each institution must provide their accountholders with an official Notice containing the FDIC's "model language." This Notice must be sent by July 29, 1990.

Although the new rules govern deposits of all types, one noticeable change affecting IRA and Keogh accountholders is the change to SEPARATE $100,000 COVERAGE LIMITS. Thus a customer with a plan of each type could have maximum coverage of $200,000 between his or her IRA and Keogh accounts. Formerly these coverages were "aggregated," with a maximum coverage limit of $100,000 between the two.

A copy of the FDIC model language has been sent (or should have been) by the FDIC to each institution. If not, a copy may be had by contacting FDIC, or Collin W. Fritz and Associates. Financial institutions may simply copy the FDIC notice format, or may send a version WITH EXACT FDIC WORDING obtained from an independent source.

In many cases, you may be able to purchase these Notices in quantity from your state banking association. If not, they are available at competitive prices from Collin W. Fritz and Associates, Ltd. Call 1-800-346-3961.

Opinion Letters—*Continued From Page 3*

The IRS has not made a prediction as to when this problem is expected to be resolved. Our rough estimate is three to eight weeks. We will keep you informed in The Pension Digest. All Collin W. Fritz prototype customers will be notified immediately of issuance. PD

QP Filers at Key District Level May Now Generate Own Data on Disk

All organizations or individuals who must file their qualified plans at the Key District level, now have an alternative to the IRS pre-printed OCR (optical character reader) form previously required.

Formerly, all submitters who used Form 5300 (for individually designed plans) or 5307 (for mass-submitter plans) were required to use an IRS-supplied form, which was printed with OCR ink on page one, and readable by IRS scanning equipment. This requirement meant that a submitter could not use photocopies. If by chance the IRS was unable to supply a submitter with the proper form, the submission could not be made until it was again available.

Now, however, those who make numerous filings at the Key District level have another option, according to IRS Notice 90-38. The alternative is a computer-generated OCR data record, submitted on disk rather than paper.

Notice 90-38 provides specific instructions on how to set up such a disk, which then must be submitted to the IRS for pre-approval. The Notice also contains instructions as to exactly what must be submitted when the Key District filing is made using the computer-generated forms.

Your sample disk must be submitted to the national office prior to August 1, 1990, and to the various Key Districts on or after that date. For a copy of Notice 90-38, send a stamped, self-addressed envelope, and $3.00 to cover reproduction and postage, to Collin W. Fritz and Associates, Ltd., Box 426, Brainerd, MN 56401. PD

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Question: An accountholder at our bank had a Qualified Plan that was terminated, and then rolled these QP funds over into an IRA here, within the required 60 day time limit.

However, our bank recently announced that it is ceasing operations. This customer is considering taking a lump-sum distribution from the recently-opened IRA (IRA #2), and rolling it over to another, previous IRA (IRA #1) at another institution. What should I advise this customer?

✔ The answer to your question—as is so often the case—is *"That depends."*

There is no problem in IRA #1 RECEIVING these funds, for an IRA can have money rolled INTO it at any time. The key point is whether IRA #2 has had any DISTRIBUTIONS from it during the previous 12 months, since only one rollover distribution per 12 months is allowed. If not, no problem.

However, if this IRA DID have a rollover distribution within the previous 12 months, then it appears that the customer could not take another rollover to extract those funds, even from a closing institution. There seems to be no "exception" language in the IRS Code to address this possibility.

Fortunately there is another option, and that is the transfer. An IRA account can have an UNLIMITED NUMBER OF TRANSFERS, insofar as the IRS is concerned. This then, would be the option that would have to be chosen under these circumstances. The funds would have to pass from one custodial institution to another, and not through the hands of the accountholder.

Question: Our bank wishes to market its IRA and Keogh services more aggressively by linking the IRAs with non-IRAs in various ways. Are there any legal or tax concerns?

✔ There certainly are. The IRS in Announcement 90-1 defined when the bank's offering of cash, products and/or services to IRA and Keogh accountholders outside of the IRA or Keogh would not constitute a prohibited transaction. What must be remembered is that all promotions are not given relief from the prohibited transaction rules; the only ones given relief are those which meet the specified requirements of the Announcement. If your bank's promotion does not meet these specified requirements, then you and your customer will have the tax mess that results from having a prohibited transaction. For a list of these requirements, send a SSAE to Collin W. Fritz and Associates.

Question: Is it true that one participant QP/Keogh plan (even those which have terminated or which were newly created in 1989) with less than $100,000 in plan assets don't need to file a 1989 Form 5500-EZ?

✔ It's awfully hard to believe, but it is true. The 1989 Form 5500-EZ contains the following instruction:

"Plans with $100,000 or less in assets. - Employers who have: (1) a one-participant plan with $100,000 or less in assets at the end of the plan year, or (2) two or more one participant plans that aggregate $100,000 or less in assets at the end of the plan year are not required to file the 1989 Form 5500-EZ.

However, if you have two or more one-participant plans and the total assets of all the plans are more than $100,000, you must file a 1989 Form 5500-EZ for each plan."

Question: The IRS sent the pre-printed 1989 Form 5500-C/R booklet to those plan sponsors who will need to file this form. Should we review this information to see if the IRS correctly pre-printed the information on page 1?

✔ Certainly. We all make mistakes, including the IRS. It appears the IRS erred more often than not in completing question 5(a)(ii), which asks whether the plan covers self-employed individuals. In many instances the pre-printed form answers "No", when in fact the plan DOES cover sole proprietors and partners. If you must correct such an error, note that item B on the top 1/3 of page 1 is to be checked if the filer has made any change to the pre-printed information, or has filled in any incomplete information. PD

The Pension Digest invites your questions and comments.
Please address to "Check It Out," Collin W. Fritz & Associates, Ltd., P.O. Box 426, Brainerd, MN 56401.