THE Pension Digest

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Misinformation About Non-deductible IRA Contributions

In the business of retirement accounts, there are common questions that must be dealt with continually. This is true not only because of congressional propensity to narrow benefits, but also because of the misinformation that is generated on these topics. In a recent **Bondy on Money** article which appeared in an Iowa newspaper, financial writer Susan Bondy addressed some of the myths "out there" on IRA deposits.

She addressed what is certainly the most common fear (and possibly the most useful marketing tool), that is the fact that Social Security is not likely to support us in retirement in the manner to which we have grown accustomed. Also, her advice on the viability of nondeductible contributions, and contributions generally, was very good. However, her comments on nondeductible contributions were not as complete or current as they should have been for depositors.

Though an accountholder is an active participant in an employer's plan, contributions to IRA accounts can still be made. The amount of the contribution that is deductible will then vary from $0 to the entire $2,000 ($2,250 if spousal contributions are made) depending upon income and marital status.

Ms. Bondy recommends that nondeductible contributions be kept in a separate account. She states that distributions might then be drawn from that account first.

Segregation of nondeductible contributions is certainly good advice from a recordkeeping or accounting standpoint. This is the reason a Form 8606 must be filed to notify the IRS of any activity regarding nondeductible contributions, both upon making the nondeductible contribution, as well as upon distributions. But it does not result in taxation in the manner indicated by Ms. Bondy. A careful reading of the instructions to that form defines nondeductible contributions as basis. The form further states that "once you have basis in your IRA(s), part of each subsequent distribution will be nontaxable until you run out of basis."

In IRS notice 87-16, the IRS addressed this very issue. Section II of the notice discusses nondeductible contributions to IRAs and states that they may be made to the same account as deductible contributions.

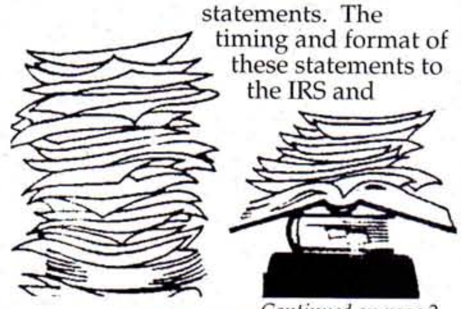
At D2 of the question and answer section, the IRS says that an individual may not designate a particular distribution as being from their nondeductible contribution. Each withdrawal is treated as a pro rata recovery of both the nontaxable portion (basis) and the taxable portion. This is true regardless of whether the nondeductible contributions are kept in a separate account with withdrawals made only from that separate account.

Section III sets out the formula to be used to find the pro rata amount to be attributed to nondeductible contributions, and therefore nontaxable when distributions are made. The calculation must be performed every year in which a distribution is made to ascertain how much of the distribution is the return of basis. The remaining amount is includable in the individual's income.

The idea of making nondeductible contributions is certainly a good one and should be communicated to accountholders. They maintain the tax deferred benefit on the earnings of these contributions, and the account will grow much faster with the tax deferral status of the interest. Give your accountholders the information they need to come to the conclusion that these too are good investments. PD

1990 IRS Forms & Statements: Mailings, Enclosures and Penalties

Each year, custodian/trustee institutions must file substantial customer tax information with the Internal Revenue Service (IRS), and provide copies of such information to their customers. This information is furnished to customers via various statements. The timing and format of these statements to the IRS and



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Also In This Issue —

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In mailing such statements to customers, you may wish to mail some of the required customer statements together. And for convenience, or by preference, you may also choose to provide the required information in a substitute format, rather than sending a copy of the official IRS form.

In addition, you may—for promotional reasons—also wish to enclose marketing information in these mailings to your IRA accountholders.

Statement Mailing Rules Vary

Caution is advised, however, because the rules regarding "1990 statements" vary depending upon the type of statement to be prepared. That is, different rules apply to the furnishing of statements to recipients, depending on the type of payment being reported and the form to be filed.

There are certain forms for which the IRS has very stringent rules. These are for payments of dividends or interest under Internal Revenue Code sections 6042, 6044 or 6049. These payments are reported on Forms 1099-DIV, 1099-INT, 1099-PATR and 1099-OID.

Other IRS forms have less stringent rules, such as 1098, 1099-B, 1099-MISC, <u>1099-R</u>, <u>5498</u>, W-2G, 1099-DIV for section 404(k) dividends reportable under Code section 6047, and 1099-INT for interest reportable under section 6041.

The primary purpose of this article is to summarize the statement rules for IRAs and pension plans. Generally, the reporting forms for IRAs/pensions must meet the less stringent rules.

However, since we think you will find the comparison enlightening, we have also summarized the more stringent rules. Commonly people incorrectly assume that the stringent rules apply to all types of statements.

Furnishing Non-Pension Statements

For non-pension forms 1099-DIV, 1099-INT, 1099-PATR and 1099-OID, you are required to furnish an official form or a substitute form to a payee, either in person or in a statement mailing by first class mail. Statements may be sent by intraoffice mail if you use intraoffice mail to send account information and other correspondence to the payee.

Non-Pension Enclosures

The freedom to mail enclosures is very limited for these nonpension forms. The only things which can be added are:

A) Forms W-8, W-9 or other 1098, 1099 and 5498 statements,

B) a check

C) a letter explaining why no check is enclosed

D) statement of the person's account reflected on Form 1099

E) W-2 and W-2P forms

F) a letter limited to explaining tax consequences of the information on the payee statement

G) certain code wording on any enclosure to which a payee statement is attached.

What IRA/Pension Statements are Required to be Prepared?

There are essentially four IRA/ pension statements which must be prepared.

Form W-2P is used to report retirement payments—including IRA payments—other than total distributions (those which close an account). Form 1099-R is used to report retirement payments which are total distributions. Form 5498 is used to report certain IRA contributions, and the year end fair market value to the <u>IRS</u>. The "January statement" is used to report to an IRA <u>accountholder</u> the year end fair market value of his or her IRA. The form 5498 or a "May statement" is used to report to an IRA accountholder their IRA contribution information.

Furnishing IRA/Pension Statements to Customers

The IRS instructions do not address very well how to furnish IRA/pension statements to customers. They do not expressly require a first class mailing. Apparently, you are simply required to furnish them to the customer in any manner. We would expect that you will probably mail these statements in separate mailings, but this may be a subject you wish to review, given the nature of the IRS instruction.

What Format Must Each Statement Take; When Must it be Furnished?

The statement for the Form W-2P information must be in the form of the government-printed official form, or on a privately printed substitute form. IRS publication 1141 explains the format that must be used on all substitute paper forms. Note that for IRS purposes a substitute statement is defined to be any copy other than Copy B of the Official Form. An IRA custodian may prepare a substitute statement itself, or buy them from a private printer or forms vendor. Any substitute must comply with the format and content requirements of Publication 1179.

We would expect that most IRA custodians will use privately printed forms. In this case, the IRA custodian does rely on the printer for compliance with the rules of Publication 1179.

You should furnish this W-2P statement/form to your customer by January 31, 1991.

You also need to furnish each IRA accountholder with a "January statement" of the value of his or her IRA by January 31, 1991. This statement can be in any written format.

The following message must appear on the January statement: "This information is being furnished to the Internal Revenue Service."

Special Instructions

At the same time, the IRA custodian must also provide each IRA accountholder with instructions similar to those that appear on the back of the official IRS form, so that the information may be properly used by the IRA accountholder or recipient in completing his or her (or a decedent's) tax returns. You should add the following provision to your January statement: "This is the fair market value (FMV) of your account at the end of the year. However, if a decedent is shown as the participant on this form, it may be the FMV at the date

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Ruling Request User Fees Reinstated

As reported in the October issue of The Pension Digest, user fees charged by the IRS for determination letters and private letter rulings lost their legislative authority when congress failed to authorize their continuance before the September 29th expiration date. We also reported on interim procedures to be followed while awaiting Congressional action on the issue of continuance of this fee schedule.

Now, through the Omnibus Budget Reconciliation Act of 1990 (OBRA) signed into law on December 5th, the previous schedule of user fees has been reinstated.

Any custodian/trustee or other entity who filed a request between the expiration and reinstatement dates without an accompanying fee will be given a reasonable amount of time to submit the appropriate fee. Such applications have not and will not be automatically returned. Any applications submitted hereafter must be accompanied by the appropriate paid-in-advance fee.

The user fee forms—8717 for Employer Plan Determination Letter Request, and 8718 for Exempt Organization Determination Letter Request—now reflect the user fee extension just recently enacted. PD

Does Lump-Sum Distribution End ERISA Protection?

If one is guided by most judgments handed down in such cases, the answer would have to be "Yes". The majority of courts have held that the ERISA anti-alienation provisions no longer apply after the plan funds have been paid to the participants

The anti-alienation provisions of ERISA-governed retirement plans (including Keoghs) are very substantial. They are intended to provide plan participants with protection against all but a very limited number of avenues for attaching or legally tapping these funds by other interests or parties. The usual exceptions are typically restricted to (a) satisfying a federal tax judgment, or (b) pursuant to a Qualified Domestic Relations Order (QDRO) in the case of divorce.

But beyond such clear-cut exceptions, when do the anti-alienation protections of ERISA become invalid, and plan assets subject to attachment and available to creditors and other parties?

One such instance was determined in an April, 1990 decision, in the case of J. Raymond Clark v. Superior Court for the District of Columbia, United States Court of Appeals.

Previously, a separation agreement had awarded Clark's ex-wife certain property, including half the benefits of Clark's Keogh account. However, prior to distribution, these funds remained in the account held by Clark.

But when Clark received a lump-sum distribution of the Keogh funds, his ex-wife filed suit in state court to enforce the separation agreement that had previously awarded her half the account balance. Clark asked the federal district court to enjoin the state court from enforcing the agreement, claiming that the anti-alienation and preemption provisions of ERISA made the agreement invalid.

Upon the district court's refusal, Clark appealed. The appellate court ruled that ERISA's provisions were inapplicable, citing the fact that—because all benefits had been paid to him—Clark no longer met the test of "is or may be entitled to a benefit." He was no longer a plan participant covered by ERISA's protections. PD

IRS Forms—*Continued from page 2*

of death. If a decedent's name is shown as the participant and the FMV is "0", the executor or the administrator of the decedent's estate may request a date of death valuation from us."

The format of the statement to be used for the Form 1099-R information or the Form 5498 information may, but need not be, a copy of the IRS form (whether printed by the government or by a private printer).

You must furnish the Form 1099-R information by January 31, 1991. You will need to furnish the Form 5498 information by May 31, 1991.

When the IRS Form 1099-R or Form 5498 is not used, it is important that the various income items be properly classified for federal income tax purposes. The following message must appear on any substitute statement: "This information is furnished to the Internal Revenue Service." As with the FMV statement, the IRA custodian must also provide each IRA accountholder with applicable instructions similar to those that appear on the back of the official IRS 1099-R and 5498 forms, so that the information may be properly used by the IRA accountholder in completing his or her tax returns.

What Additional Enclosures With Pension Statements? Rules for Statement Mailings

The IRS instructions do not address this question for the Form W-2P. Thus, the most conservative approach would be to follow the stringent rules discussed previously for the non-pension mailings.

The IRS instructions expressly address this issue for Forms 1099-R and 5498. The instructions read: "You may combine the statements with other reports or financial or commercial notices, or expand them to include other information of interest to the recipient." This rule is very different from the stringent rule which applies to the Forms 1099-DIV, 1099-INT, 1099-PATR or 1099-OID.

Penalties for Failure to Timely File Statements with the IRS

The IRS states very clearly in the 1990 instructions that the penalties under sections 6721 and 6722 do not apply to the filing of Form 1099-R or Form 5498. The instructions contain a warning that Congress may consider legislation which would apply the sliding scale penalties of sections 6721 and 6722 to Form 1099-R and Form 5498. It appears that Congress did not pass such a change for 1990 reporting purposes.

The instructions contain no discussion of the "January statement." Presumably the penalty would be the same as it is for the form 5498.

Section 6721 sets forth the "scaled" \$15/\$30/\$50 per account penalty (varying by degree of lateness) for failing to file a correct statement with the IRS in a timely fashion. This penalty increases to the lesser of 10% or \$100 per statement for intentional disregard of the requirement to timely file with the IRS.

Section 6722 sets forth a nonscaled \$50 penalty for failing to furnish the payee with the statement in a timely fashion. This penalty increases to the lesser of 10% or \$100 per statement for intentional disregard of the requirement to timely furnish this information to the customer/payee.

In the case of Forms 1099-R or W-2P, the deadline to file with the IRS/SSA is February 28, 1991. The penalty for late filing of these forms for non-IRA plans is \$25 per day, to a maximum of \$15,000, unless you can show reasonable cause. (Section 6047 is the authority for the IRS requiring the Form 1099-R or W-2P to be completed.) However, the penalty is \$50 per failure for IRA information reporting. The authority for the IRA penalty is section 6693(a).

For Form 5498, the deadline to file with the IRS is May 31, 1991. Penalty for late filing is \$50 per return, with no maximum, unless—again—reasonable cause is shown. The authority for this penalty is section 6693(a).

Penalties for Failure to Timely Furnish Statements to IRA Accountholder

Section 6693(a) provides a penalty of \$50 for each failure, unless such failure is due to reasonable cause. This penalty would apply for all four IRA statements. PD

Contribution Calculation For Self-Employed Now More Complicated Than Ever

On Wednesday, December 12, 1990, the Wall Street Journal reported that it would no longer be possible to apply the rule of thumb figures to Keogh or SEP contributions for self-employed individuals. (Up until now it has been possible to apply a 13.04% figure to a contributor's net income to determine the maximum contribution for the 15% limit.) It is no longer possible to use the 13.04 figure or any of the other nice clean tables that have been available in the past to figure the other percentage equivalencies, without an added step.

The reason for the change is that new rules now allow self-employerd individuals to deduct one-half of the amount of the Social Security tax that they pay. (These new rules apply for tax years 1990 and thereafter, per IRS Code

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Question: Should an IRA accountholder name a revocable living trust as his or her IRA beneficiary?

✔ Generally, we do not feel an IRA accountholder should name a revocable trust as his or her IRA beneficiary.

In the November issue we answered a similar question—can our accountholder transfer an IRA to a living trust?

We said that an IRA cannot be owned by the revocable trust, but the revocable trust could be the beneficiary of the IRA account.

The pertinent question now is: Should the revocable trust be the named beneficiary of the IRA?

We think not. An IRA is itself a revocable trust. By naming another non-IRA revocable trust as the beneficiary the only thing which seems to be accomplished is to simplify somewhat the transfer of property upon a death. Rather than having each trust have separate beneficiaries, there is only one document which controls the transfer of property to beneficiaries. In <u>some</u> cases it <u>may</u> be worthwhile to have just one document controlling the transfer of property.

However, we do not believe this simplification is sufficiently valuable to override the fact that a single life expectancy factor must now be used for "70-1/2" calculation purposes, since the trust is revocable. This would significantly speed up distributions.

Remember, to qualify to use a joint life expectancy factor, the IRA accountholder must have designated a living person as the beneficiary. There is a special exception which permits the use of beneficiaries of an irrevocable trust, but this special exception does not extend to the beneficiaries of a revocable trust.

Question: Our accountholder turned 70 in 1990 and will be 70-1/2 in 1991. We know that his required beginning date is not until April 1, 1992. Can he make a contribution for 1991? . . . in 1991 for 1990?

✔ The general rule for question #1 is no. An accountholder cannot make a contribution for the year in which 70-1/2 is attained. Your accountholder could make a contribution for 1990 and can make it until April 15, 1991, provided it is designated in writing as a 1990 contribution. Even though it may seem like a year in which no action is taking place—that is, no distribution, yet no contribution can be made—remember that the April 1, 1992 first distribution is actually the distribution for 1991. The only exceptions to this general rule are rollovers, which you can take for a 70-1/2 accountholder, and for a 70-1/2 accountholder who is making a contribution for a spouse who <u>has not</u> yet reached 70-1/2.

Question: Our accountholder is under 59-1/2 and is disabled. May distributions be given to that person without penalty, and what documentation do I need in our bank file?

✔ Disability is one of the exceptions to the 10% premature distribution tax that is levied on distributions to accountholders who are not yet 59-1/2. (The others are substantially equal periodic payments, rollovers, or death distributions.) The form to be used for this situation is the Schedule R attachment to the 1040 form. The form is entitled Credit for Elderly or the Disabled and it should be filled out by the accountholder and signed by their physician. At this writing the IRS has just issued the 1990 form. A copy of this attachment is what you must keep in your file. It is up to the accountholder to file Schedule R and Form 5329 with his own return to avoid payment of the 10% premature distribution tax.

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.

Self Employed Contribution—*Continued*

section 401(c)(2)(A)(vi).) These breaks must be factored into the already befuddling concept that net income must be reduced by the contribution before figuring the contribution.

For each SEP or Keogh accountholder, look to their Schedule C (line 29) or Schedule F (line 36) for their net income. From this you must now subtract one-half of the tax that the individual has paid on self-employment income for old age, survivors and disability, as well as hospital insurance.

After arriving at this figure you can then apply the percentage table that has been useful in the past. A couple of examples will help illustrate.

Your accountholder earns $50,000 and wishes to make a 15% contribution. First, figure his Social Security payments at $50,000 x .1530 (this is 12.40% for old age, survivors and disability and 2.90% for medicare) for total payments of $7,650. Subtract one-half of that, or $3,825, from $50,000 for an adjusted net income figure of $46,175. To this figure you apply the 13.04% that has been used in the past. These steps will give the contribution amount, which is $6,022.61.

$50,000.00	(Net Income)
<u>-3,825.00</u>	(1/2 of FICA or $50,000 x .1530 ÷ 2)
$46,175.00	
<u>x .1304</u>	
6,022.61	(Contribution)

In a second example, your self-employed customer has net income of $110,000 after making a 10% contribution for her two employees. What will be her contribution amount? From the $110,000 subtract one-half of $7,848.90, the maximum Social Security amount. $3,924.45 is the maximum deduction and the amount to be subtracted. $106,075.55 then is the figure to which you apply your equivalency table figure for 10%, or 9.09%. The amount of the contribution for this accountholder is $9,642.27.

$110,000.00	(Net Income)
<u>-3,924.45</u>	(1/2 of Social Security Tax)
$106,075.55	
<u>x .0909</u>	(Equivalency for 10%)
$9,642.27	(Pension contribution amount)

While an extra step has been added (deducting from net income one-half of the self-employed tax), it is not one that is beyond comprehension. With the above formula and the tables that you have been using in the past, the new deduction can be calculated quite quickly.

You have our express permission to photocopy this article for your customers so that they may give it to their tax accountant. PD

UNADJUSTED PLAN CONTRIBUTION FORMULA PER ADOPTION AGREEMENT	ACTUAL PLAN CONTRIBUTION PERCENTAGE FOR SELF-EMPLOYED INDIVIDUAL
1%	.99%
2%	1.96%
3%	2.91%
4%	3.84%
5%	4.76%
6%	5.66%
7%	6.54%
8%	7.40%
9%	8.25%
10%	9.09%
11%	9.91%
12%	10.71%
13%	11.50%
14%	12.28%
15%	13.04% *
16%	13.79%
17%	14.53%
18%	15.25%
19%	15.96%
20%	16.66%
21%	17.35%
22%	18.03%
23%	18.70%
24%	19.35%
25%	20.00% **

* Maximum for Profit Sharing
** Maximum for Money Purchase or Combination of Plans