THE Pension Digest

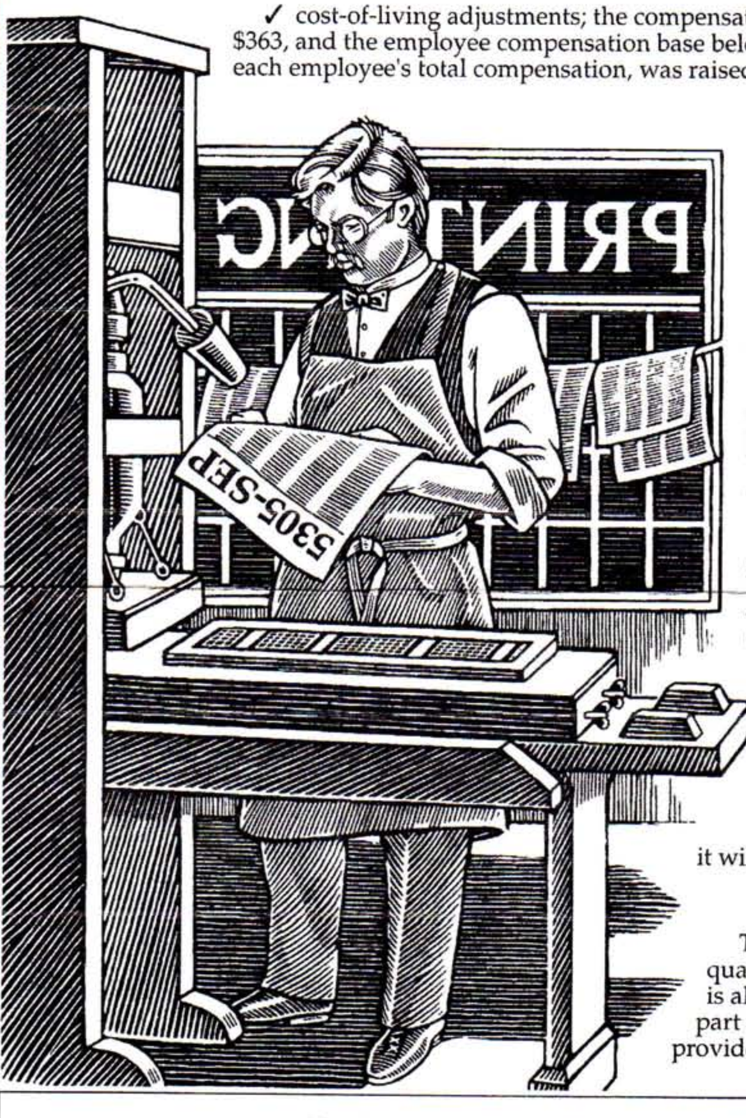
Published Since 1984 | Collin W. Fritz & Associates, Inc., *"The Pension Specialists"* | July, 1991

IRS Issues New 5305-SEP Form

The IRS in June of 1991 released its revised 5305-SEP form, also known as the Simplified Employee Pension plan. On it the employer specifies the requirements for employee participation in the plan (within IRS guidelines), and agrees to the IRS limitations and requirements on contributions.

There are only minor changes to the previous 5305-SEP form, which was last revised in 1988. These changes include:

✓ addition of an estimate of the amount of time needed to study the form, prepare it, and handle recordkeeping, and a solicitation of comments on the actual time required, and how the form could be further simplified.



✓ cost-of-living adjustments; the compensation threshold for plan participation was raised from $300 to $363, and the employee compensation base below which all contributions must be the same percentage of each employee's total compensation, was raised from $200,000 to $222,220.

✓ clause clarifying permissibility/ impermissibility of discriminating in favor of highly compensated employees. The previous form stated that "In making contributions, you may not discriminate in favor of any employee who is highly compensated." The 1991 form adds the clause "... if you use Form 5305-SEP."

This means that, in making contributions, employers who use a SEP prototype instead of the IRS 5305-SEP form *may* discriminate in favor of highly compensated employees.

✓ under the Questions and Answers section (page 2) describing what a SEP is, the previous form stated that "The $30,000 (contribution) limitation referred to...may be increased by 1/4 of the dollar limitation in effect under section 415(b)(1)(A)."

This clause refers to the relationship between defined contribution plans (such as a SEP) and defined benefit plans. When the defined benefit plan limits — also under section 415(b)(1)(A) — exceed $120,000 as indexed for cost-of-living (COLA) increases, the defined contribution limits will then rise above $30,000. With defined benefit limits currently at $108,963, this $120,000 is not expected to be reached until 1992 or 1993.

At this time the $30,000 limit will begin rising in accordance with COLA increases.

The 1991 5305-SEP form does not include this clause. Perhaps it will be reinstated on the form when the $30,000 limit is exceeded.

Form 5305-SEP Available From CWF

The latest version of Form 5305-SEP is now available in quantity from Collin W. Fritz and Associates, Ltd. Form 5305-SEP is also available from the IRS in limited quantities, but is not in 2-part carbonless form like the CWF version, which automatically provides an institution copy for your files.

Continued on page 4

QP-*to*-IRA Rollovers: *Several Attempts That Failed*

The IRS and the tax courts have recently issued a number of rulings indicating that – many times – a recipient of a pension distribution is not qualified to roll over the paid funds to an IRA. Now more than ever, you will want to have your customers talk with their tax advisors before they decide to take and/or roll over a distribution from a qualified plan to an IRA. These following situations will show that rollovers are not getting any simpler.

Situation #1

In private letter ruling 9114034 (January 9, 1991) the IRS concluded that the individual did not have a partial distribution within the requirements of the tax laws and therefore the amount he had been paid did not qualify to be rolled over.

Case Facts

The individual worked as a state employee. This state had two pension plans — an older Plan X and a new Plan Y. The terms of the two plans were not identical. Plan X had provided for nondeductible contributions. The option was given to participants of Plan X to transfer their account balances to Plan Y and then (1) be paid a refund of his or her accumulated employee contributions plus interest and (2) have their retirement benefit calculated and paid from Plan Y. It was required that the transfer from Plan X to Plan Y take place prior to retirement.

On June 13, 1990, the individual notified his state employer that he was going to retire on July 1, 1990. He requested the transfer from Plan X to Plan Y. He was paid his accumulated employee contributions plus interest. He rolled over these funds to an IRA. The total of his contributions plus interest was more than 50% of his account balance.

The IRS ruled that this distribution did not qualify as a partial distribution as defined in the tax code because it was not paid on account of his death, disability or separation from service.

The IRS concluded that the reason for the payment of the money to him was because of his decision to transfer from Plan X to Plan Y. Although he certainly was contemplating his retirement, the reason for the distribution was the transfer (to take advantage of being in Plan Y) and not his separation from service.

A technical response to be sure, but one which the IRS made. A point to remember is that nondeductible employee contributions are not eligible to be rolled over, so the most that could have been rolled over would have been the interest earned by these contributions.

Situations #2 & #3

The IRS in the following two situations also reached technical results with harsh tax consequences to the recipient or proposed recipients of a pension distribution.

In private letter ruling 9102044 (October 9, 1990) and private letter ruling 9108020 (November 26, 1990) the IRS faced similar questions and reached similar results.

A large corporate employer with many divisions sold one of its divisions to a third party. The employees of this division were to be paid their pension account balances and they wanted to know if they could roll over these funds to an IRA. The purchasing third party was a partnership and not a corporation.

Code section 402(a)(5) indicates that a plan termination will substantiate a rollover. However, a large corporation does not terminate its entire plan when it pays out the funds of just one division. Thus, the departing participants do not qualify to roll over the funds to an IRA because of a plan termination under the normal rollover rules.

To solve this problem, Congress enacted Code section 401(a)(6)(B) so that some "partial" terminations would qualify to be rolled over.

In certain special situations a payment from a plan will be treated as if the plan had terminated even though it really has not. For example, if a corporation sells to another corporation the assets it uses in a trade or business and the employees of the seller become the employees of the buyer, then a distribution from the seller's plan to those employees could be eligible to be rolled over if special rules are met.

The tax code and the legislative history only speak in terms of one corporation selling to another corporation.

Thus, a sale from a corporation to a partnership would not meet the special requirements. Since the purchaser entities in both of the private letter rulings were partnerships, the distributions to the employees of the sold divisions did not satisfy the rules and thus they could not roll over their distributions. Again, a fairly harsh and technical result. One would expect that Congress will in the future change the law to prevent this consequence.

Please note that the IRS private letter rulings did not address whether the employees would meet any of the other requirements that would authorize a rollover.

Situation #4

Situation # 4 arises from a U.S. Tax Court decision and not a private letter ruling. This decision is very important because it is one of the first to review the IRS' temporary regulation that an IRA rollover contribution must be irrevocable.

Overview

After a terminating employee received a lump-sum distribution from his employer's retirement trust, he rolled over $10,000 to an IRA, and reported the remaining portion as ordinary income, subject to 10-year averaging.

Approximately three years elapsed before the individual received an IRS deficiency notice, telling him that he could not 10-year average any portion of the amount he did not roll over. He owed taxes on the portion which was not rolled over at ordinary income tax rates.

Internal Revenue Code section 402(a)(6)(c) expressly denies 5/10 year averaging treatment for that portion of a lump-sum distribution which is not rolled over. By not knowing about 402(a)(6)(c) he made a tax blunder of major proportions.

Could he correct it?

The individual then filed an amendment to his earlier tax return, and attempted to revoke the $10,000 IRA rollover election, to enable him to use 10 year averaging on the entire lump sum distribution.

The IRS Disagrees

This tactic was disallowed by the IRS. The IRS cited Temporary Regulation 1.402(a)(5)-1T, Q & A-3 and -4, which states that rollover contribution elections made on income tax returns filed *after* March 21, 1986 (as this taxpayer had done) are irrevocable.

Taxpayer Cites Private Letter Rulings in His Defense

Despite this clear-cut evidence of failure to comply with the most recent

Continued on page 3

QP-to-IRA—*Continued from page 2*

Temporary Regulation, the taxpayer in his defense cited three private letter rulings, all relying on earlier Temporary Regulation 1.402(e)(4)(B)-1 (which had never been revoked or withdrawn by the IRS). In these private letter rulings, the taxpayers had been allowed to revoke an IRA rollover, file amended returns and report the distributions as ordinary income subject to 10-year averaging treatment.

Tax Court Upholds IRS Position, Ambiguously

The taxpayer's Temporary Regulation citations failed to sway the court. But rather than refer to the Temporary Regulation that unequivocally eliminates rollover revocation for tax returns filed after March 21, 1986 — as it could have — the court based its rejection of rollover revocation on the earlier Temporary Regulation. It pointed out that the appellants (taxpayers) in the three private letter ruling situations cited, had complied with a three-year grace period (Code section 6511) for filing a claim for credit or refund, and then re-filing their tax return for that year, after revoking the rollover election.

In the case under consideration by the court, this taxpayer *had not met* the three-year deadline because the IRS deficiency notice had come after this time period had elapsed.

A Door Left Open?

By issuing its opinion this way, the court seems to be limiting this particular ruling to saying that the taxpayer's option to revoke his rollover election was lost by his having missed the three-year deadline that had been in place under the earlier Temporary Regulation.

The court seems to have ruled only as widely as necessary. In this case, it did not even cite the more recent Temporary Regulation that has since made rollovers irrevocable. Or was it leaving the door open to future arguments over the question of which Temporary Regulation is controlling? Perhaps an appellant who met the three-year limitation could still win such a case.

There should be — but seems not to be — clear IRS direction as to when or whether a later Temporary Regulation replaces a prior Temporary Regulation, or replaces a prior final Regulation. This case is further evidence of that fact.

In This Case:,Tough Tax Consequences

For this particular taxpayer, his IRA rollover election invalidated his choice

Continued on page 4

Continued Annuity Payment Not Guaranteed by PBGC

In a December, 1990 letter, the Pension Benefits Guarantee Corporation was asked whether it would guarantee annuities distributed as part of the termination of a pension plan, if the company from which the annuities were purchased should fail. The question is a key one, for it reflects on the long-term asset protection of a pension plan participant, and also on the exposure and solvency of the PBGC itself.

After a legal analysis of the statutes that pertain to its responsibilities, PBGC responded that its role is limited by the Employee Retirement Income Security Act (ERISA) which established it in 1974. This Act requires that PBGC guarantee the payment of benefits when a single-employer plan terminates without sufficient assets to pay for those benefits. In such cases, PBGC usually becomes trustee of the plan, and pays the monthly benefits.

In the case of a terminated plan that *does* have sufficient assets to pay benefits prescribed under the plan (a "standard" termination), PBGC will oversee a plan administrator's allocation of plan assets to ensure that each participant receives their proper benefits.

Where PBGC Involvement Ends

The PBGC's role is centered upon — and is limited to — plan termination. This — in the words of the agency's analysis — is the "insurable event." The final distribution of all plan assets completes the termination process, and ends all obligation of the PBGC. Most often, when a plan terminates, it uses the plan assets to buy single premium life annuities from insurance companies for the participants. Once the annuity is purchased, the terminating process is considered finished for PBGC purposes. The Executive Life of California insolvency has demonstrated that the actual payment of the annuity proceeds is another issue altogether.

PBGC Not Liable

PBGC <u>does not</u> remain in a position of liability for the life of an annuity. Any subsequent failure of an insurance company to pay an annuity is *not* an event insured by PBGC. According to the analysis, such an extended responsibility and potentially extensive exposure to risk was not part of ERISA's intent, and not allowed for in the PBGC funding mechanism, which is via a premium paid by covered plans.

A PBGC representative continued that ". . . had Congress intended the PBGC to guarantee against the subsequent failure of the insurance company from which annuities were purchased, it would have designed a premium to protect PBGC against that continued exposure."

Commentary

This stated lack of responsibility for annuities once they have been issued, clearly leaves pensioners in a vulnerable position.

In some states there are "insurance pools" which cover policyholders if a company with accounts in that state should become insolvent. However, this varies state-to-state, with no uniformity or federal government oversight. Perhaps more significant, there is no national insurance program for annuities comparable to FDIC's coverage of bank, thrift or credit union deposits.

An Ironic Situation

Further, there is some irony in the PBGC's disassociating itself from continued annuity liability, when that agency itself has used its administrative clout to strongly induce terminating plans to distribute plan funds in the form of annuities rather than lump sum distributions. PD

Product/Service Update

Enhanced MINCAL 4.2 IRA RMD Software Released

Retirement plan software can greatly simplify the in-bank handling of various IRA administration functions. Handling Required Minimum Distributions is clearly one such area. The right RMD software can transform a tedious, error-susceptible process into a relatively easy and certain one.

Though there are several RMD software products on the market, MINCAL by CWF & Associates is among the best, with features that now make it even more invaluable to those who administer IRAs.

Some New Features Included in MINCAL 4.2 are:

★ Pre 59-1/2 substantially equal periodic payment distributions capability. This feature utilizes the RMD, amortization and annuity factor methods.

★ A new year-end-balance report has been provided to allow verification of year-end balances.

★ All reports can now be printed in alphabetic, social security or IRA account number sequence.

★ You can now print out the various life expectancy tables which MINCAL uses for making its calculations.

★ The backup option has been enhanced to support all types of high density 5-1/4 and 3-1/2 inch diskette drives. In addition, the backup option will now backup all letter templates.

★ A new year-end distribution report has been created. This report can optionally also do a year-end clear of all year-to-date distribution fields.

In addition to these and other new program additions, MINCAL 4.2 retains it important capabilities to . . .

★ accept downloaded data from a mainframe computer.

★ generate reports and create personalized letters — with mailmerge capability — to aid marketing or communication efforts.

★ generate RMD checks.

★ provide worksheets for customer and file use.

★ track past and future payouts.

★ assist customers in choosing distribution options.

For further information on MINCAL 4.2 and other retirement plan software products, contact John Olsen or Dick Clement at (800) 346-3961. PD

✓✓✓✓✓✓✓Check It Out

Question: Our IRA accountholder is 73 years old in 1991. For his required minimum distribution calculation, he originally had named his wife (who is the same age as he is) as his sole beneficiary. Therefore, the joint life expectancy factor for the RMD calculation was based on his age and his wife's age, and they also elected to use recalculation. In July of 1991 he changed his IRA beneficiary. He named his irrevocable trust as his IRA beneficiary. There are two beneficiaries of the trust — a son age 45 and a daughter age 42. How does this change in beneficiary (i.e. naming his irrevocable trust) affect the calculation of his required minimum distribution for 1991 and subsequent years?

✓ Answer. A number of RMD rules must be applied. First, there is the rule that a change in beneficiaries will not affect the calculation for the year during which the change occurs (i.e. 1991) but it may affect future years (1992 and thereafter).

The second rule to be applied is that a change in a beneficiary after the required beginning date cannot have the result of allowing the required minimum payment schedule to be slowed.

Since the oldest of the "new" beneficiaries is younger than the spouse, the RMD calculation would still be based on the spouse's life expectancy factor, even though she is no longer the beneficiary. To allow otherwise would be to allow the payment schedule to be slowed.

If the new beneficiary had been his brother, who is four years older, the RMD calculation would change because substituting older beneficiary speeds up distribution. When a change is required, the rule is that you determine the life expectancy factor schedule under the assumption that this new beneficiary had been the original beneficiary, but this new schedule is used only for those years occurring after the change.

Question: What would happen in the above situation if the irrevocable trust was added as a 50% beneficiary and the spouse was still to receive 50%, but the spouse was only 33 years old?

✓ Answer. The analysis used above also applies to this situation except the MDIB rules (Minimum Distribution Incidental Benefit) come into play since the additional beneficiaries are older than the spouse. For 1992 and subsequent years, 50% of the account balance would be divided by the life expectancy factor based on the spouse. We have assumed that the MDIB rules will not apply to the spouse's portion of the IRA account, which is the result if the spouse's portion of the fund is accounted for separately. 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.

QP-to-IRA—*Continued from page 3*

of 10-year averaging for the remainder of his lump-sum qualified plan distribution. Since he could not revoke the rollover, the remainder of his lump-sum distribution in effect became taxable as ordinary income *in its entirety*, in the year it was distributed.

It was a lesson clearly learned the hard way. PD

New 5305-SEP—*Continued from page 1*

For a limited time, CWF is offering a substantial discount below catalog pricing:

	25	50	100
2-part carbonless	$6.50	11.50	20.00
Non-carbon	$3.25	5.00	7.50

Other quantity price quotes are available by calling 1-800-346-3961. PD