THE Pension Digest

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Time to Begin Planning for IRA Reporting

Besides handling day-to-day IRA transactions properly on a year-round basis, financial institutions must also meet very important reporting requirements at key times of the year by providing such reports to the IRS and to their IRA customers.

The information that must be provided includes amounts of total distributions, partial distributions, contributions for the year, and the IRA's year end fair-market-value (FMV). Just as important as the correctness of these reports, is the timeliness with which they are provided by custodian institutions.

Reporting Deadlines

In this issue we'll concentrate on those statements that have the earliest reporting deadline, January 31, 1992. This includes the January "customer statement" and the form 1099-R. In a future issue we'll discuss the form 5498 - which has a deadline of May 31, 1992 - in greater detail, though we may of necessity make references to it here.

The "January Statement"

This statement to customers provides them with information on the December 31 fair market value (FMV) of their IRA account, and must be provided by January 31 of the year following the close of the prior tax year.

There is no special form required for this communication to customers. It can be in any written format. It must, however, contain the following message:

"This information is being furnished to the Internal Revenue Service."

...Who is Entitled to Receive a Customer Statement?

IRA accountholders who have an account balance as of 12/31, or on their date-of-death, should receive a customer statement. But those who have either closed an account, transferred or rolled all IRA funds out of an institution before December 31, need not be given a statement by that institution. It has instead become the responsibility of the new custodian to issue the customer statement. An ex-custodian MAY choose to issue this statement if it's more convenient than modifying its computer program to not generate a report. But it need not do so. For a large institution with many IRAs, not generating this can mean a big saving.

...Notes on Deceased Accountholders

Further distinctions should be considered in cases of FMVs of deceased accountholders. For such accountholders, the IRS allows financial institutions to provide the actual date-of-death valuation, or to use what is called the "alternative method."

This alternative option allows institutions to list the FMV as $0.00, which (unless the accountholder died on December 31) would be the value as of 12/31, because the account's funds would have passed to any beneficiaries by that date.

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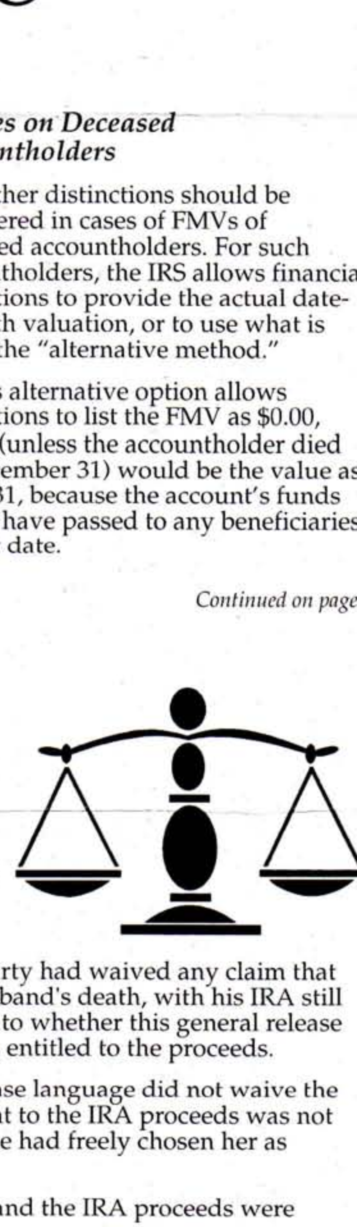
Pensions & The Courts — Another Beneficiary Case



Although ERISA's protections of IRAs have proven penetrable in some courts, particularly in tax situations, IRA provisions have remained particularly intact in divorce/separation and spouse-beneficiary situations. This was reaffirmed in a recent decision by the U.S. Court of Appeals in Atlanta.

Under a couple's separation agreement, each party had waived any claim that they might have "against the other." Upon the husband's death, with his IRA still listing his ex-wife as beneficiary, the issue arose as to whether this general release language applied to the IRA, and whether she was entitled to the proceeds.

The court ruled that this particular general release language did not waive the ex-wife's rights as beneficiary. It ruled that her right to the IRA proceeds was not based on a "claim" against the husband, because he had freely chosen her as beneficiary, without any obligation to do so.

Therefore the separation waiver did not apply, and the IRA proceeds were rightfully hers. PD

Further Commentary on Federal vs. State Withholding from IRAs

Last month in our Check-It-Out section we discussed the issue of income tax withholding from IRAs, prompted by a question from a reader in Iowa. Legislation soon to take effect there may be a harbinger of things to come in other states, in terms of determining when an accountholder can or cannot elect-out of federal and/or state withholding. It appears quite likely that financial institutions and their IRA accountholders in many states may be faced with the need to distinguish between IRA distribution withholding for state vs. federal income tax.

And, if Iowa is any example, it may foreshadow debate over whether residents and nonresidents must play by the same withholding rules.

To serve as an example of what may lie ahead, here is the substance of the Iowa legislation example, as described to us by the Iowa Department of Revenue:

• current Iowa law technically does not prescribe an option for nonresidents to elect-out of withholding. New legislation taking effect January 1, 1992, is said to reaffirm this. **However it is said that the Iowa Governor objects to this disparity,** and has expressed his feeling that the regulation should not be enforced, and nonresidents should be allowed to elect-out of withholding.

Legislation taking effect on this date would also require RESIDENTS' withholding to be treated in this fashion:

• *if an institution uses ONE withholding election form, then both state and federal withholding will be treated the same way.*

• *if TWO election forms are used, but only the federal is signed, then the federal election controls both federal and state withholding.*

• *in order to provide an opportunity for customers to withhold differently — i.e. to have withholding taken for state or federal, but elect-out of the other — an institution must use, and have signed, two separate election forms.*

In Our Opinion

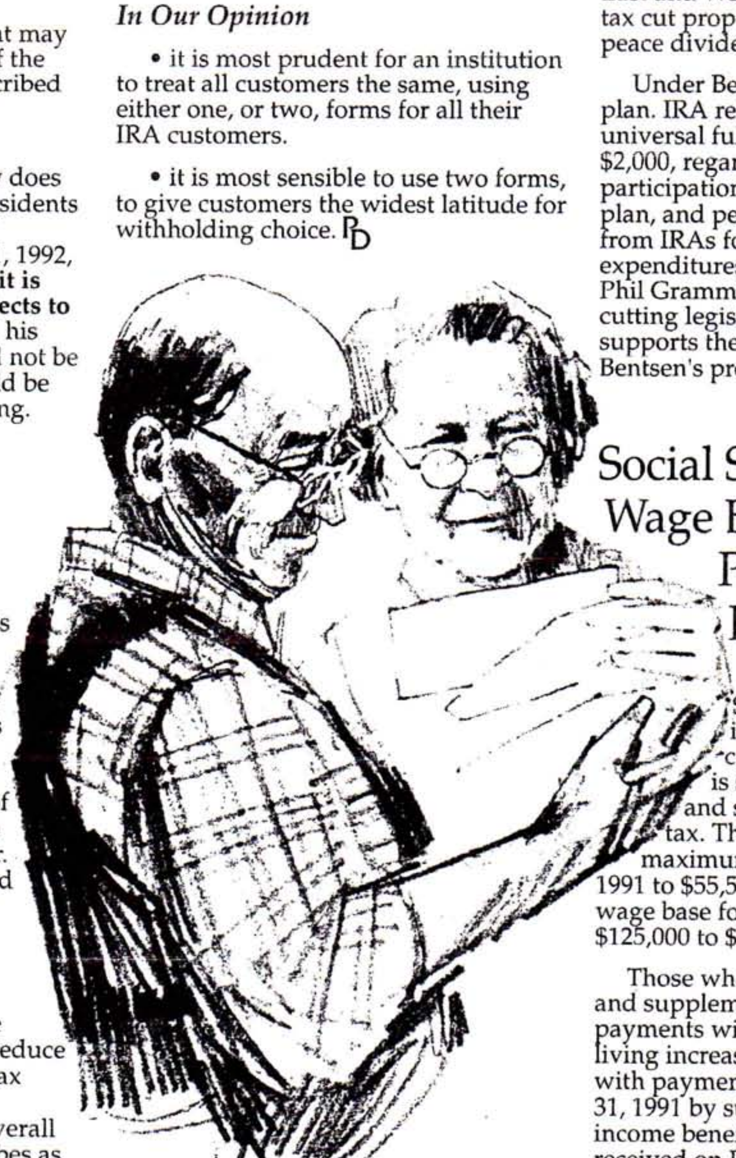
• it is most prudent for an institution to treat all customers the same, using either one, or two, forms for all their IRA customers.

• it is most sensible to use two forms, to give customers the widest latitude for withholding choice. PD

Pension Assets Important in Nation's Saving

Despite legislation in the 1980's that reduced IRA and pension savings dramatically, pension growth relative to the nation's gross national product (GNP) has been dramatic. From a status of only 2% of GNP in 1950, pension fund assets have risen to a level of 17% of GNP in 1990, according to Stanford University economist Dr. John Shoven, in a study sponsored by the Association of Private Pension and Welfare Plans.

In keeping with others in government and the pension industry, Shoven believes that the federal government's attempt to reduce the federal deficit by decreasing tax incentives for making pension contributions has severely hurt overall national savings, which he describes as "the most reliable method to strengthen the economy in the long run." PD



Bentsen Identifies Funding Source

Senator Lloyd Bentsen (D–Texas), a longtime advocate of IRA reform as a means of stimulating greater national savings, has finally described the mechanism by which he proposes to replace tax revenues that would be lost by restoring greater tax-deductibility to IRAs.

Though it may seem somewhat simplistic, and less than a revolutionary solution, Bentsen proposes to replace the estimated $25 billion five-year tax revenue loss through a 5% reduction in defense spending over the next five years. Many have projected the availability of additional tax dollars as a "peace dividend," now that political reform in the Soviet Union and Eastern Europe has reduced tensions between East and West. But this is one of the first tax cut proposals that has identified the peace dividend as a funding source.

Under Bentsen's five-year tax cut plan. IRA reform would include universal fully deductible IRA limits of $2,000, regardless of a worker's participation in an employer retirement plan, and penalty-free withdrawals from IRAs for certain identified expenditures. Texas Republican Senator Phil Gramm — who has introduced tax-cutting legislation of his own — also supports the IRA provisions of Bentsen's proposal. PD

Social Security Taxable Wage Base, Benefit Payments Increase

Changes in Social Security for 1992 include an increase in the taxable and creditable earnings base that is subject to social security and self-employment income tax. This base rises from a maximum amount of $53,400 in 1991 to $55,500. Similarly, the maximum wage base for Medicare will rise from $125,000 to $130,200.

Those who receive social security and supplemental security income (SSI) payments will receive a 3.7% cost-of-living increase. These will be effective with payments received on December 31, 1991 by supplemental security income beneficiaries, and payments received on January 3, 1992 by social security beneficiaries. PD

IRS Responds to "Surviving Spouse" Questions

The August, 1991 Pension Digest featured IRS responses to several key questions concerning IRA beneficiary and 70-1/2 distribution questions. Of particular interest was the IRS position that a surviving spouse beneficiary has a virtually unlimited right to treat a decedent's IRA as their own. Such an election can be made at any time, even if distributions have commenced under one of the other distribution methods.

. . . Further Follow-up

A follow-up letter sent to the IRS in August for additional clarification on spouse beneficiary questions has brought a further response, from Mr. Wm. B. Hulteng, Acting Chief, Employee Plans Rulings Branch, as outlined below.

Q. What rules are distributions from an IRA (that a spouse has elected to treat as his or her own) subject to?

A. In general, distributions from an IRA that a spouse has elected to treat as his or her own are subject to the mandatory distribution rules of sections 401(a)(9) and 408(a)(6) of the Internal Revenue Code. Distributions must be made using the required beginning date of the surviving spouse. Thus, such a surviving spouse under age 70-1/2 need not begin receiving distributions from his or her "new" IRA prior to attaining age 70-1/2, even if the deceased IRA holder was over age 70-1/2 at the time of death.

Q. How are the minimum distributions of that surviving spouse calculated, once that spouse reaches age 70-1/2?

A. Calculating the amount of such a surviving spouse's required distributions for a particular calendar year is done by referring to his/her attained age in that calendar year (and the attained age of the electing spouse's designated beneficiary in that calendar year, if applicable. In general, a surviving electing spouse may designate a beneficiary in order to comply with the requirements of section 401(a)(9)(A)(ii) of the Code).

Q. For purposes of calculating distributions, when does a surviving electing spouse's IRA "come into existence?"

A. In general, an electing surviving spouse's IRA as described in regulation section 1.408-8 is treated as coming into existence in the calendar year in which the election is made. As of December 31 of the calendar year prior to the year of election, the IRA has no account balance and thus may be treated as having an account balance of "zero." (CWF note: remember that when an accountholder dies, the FMV or account balance as calculated under the IRS' "alternative method" shows up as $0.00, because the account balance has become the property of any beneficiary or beneficiaries.)

Q. If the surviving spouse is 70-1/2 in the year that he/she makes the election to treat a spouse's IRA as their own, how will the required minimum distribution be calculated for the year in which the election was made?

A. The required minimum distribution for the year of election will be computed as of December 31 of the last pre-election year. PD

IRA Reporting—*Continued from page 1*

This alternative method is easiest, which is why it's chosen by most institutions. But there are situations in which an accountholder's estate would need the actual value on the date-of-death. If an institution uses the simpler "alternative method", then the following or essentially similar information must appear on the customer statement: "This is the fair market value (FMV) of your account as of the end of the year. However, if a decedent is shown as the participant on this form, the FMV may be that as of his/her date of death. If the decedent's name is shown as the participant and the FMV is shown as $0.00, the executor or the administrator of the decedent's estate may request a date-of-death valuation from us."

Identifying an Inherited Account for Customer Statements

Except in the case of a spouse who treats an inherited IRA as their own, inherited accounts must be identified as such on the January customer statement, and on the Form 5498. For example, wording such as "Brian Smith as beneficiary of Joan Smith" must appear. If or when a spouse treats such an inherited account as their own - by making a regular or rollover contribution to it, or by not taking distributions from it as required by Code section 401(a)(9)(B) - then the IRA accountholder title would revert to simply the beneficiary's name..."Brian Smith" for example.

The same account titling procedure described above for the January customer statement applies equally to the 5498.

Customer Statements and the 5498 Exception

The 5498 contains contribution information and the 12/31 fair market value of the IRA. It (or an IRS-approved substitute) is provided to the IRS for all customers, and a copy sent to most customers, by May 31. Although we will not discuss the Form 5498 at great length in this article, it bears mentioning that if a proper January customer statement was sent in a timely fashion, a 5498 copy may NOT have to be sent to some customers. The 5498 needs to be sent only to those customers who have had either regular or rollover contributions during the preceding year.

But in order to be exempted from having to send a 5498 to customers with no contributions, certain specific language must be on the customer statement. This language tells customers that their custodian institution will provide the FMV of their IRA to the IRS.

CWF's version of this REQUIRED language appears below. (Paragraph two repeats information from the previous section entitled NOTES ON DECEASED ACCOUNTHOLDERS):

"We will furnish to the IRS by May 31, 1992, the Fair Market Value of your IRA as indicated above. This is reported on the magnetic media equivalent for the 1991 Form 5498 (Individual Retirement Arrangement information)."

"If a decedent is shown as the participant on this form, it may be the FMV at date of death. If a decedent's name is shown as the participant and the FMV shown is -0-, the executor or administrator of the decedent's estate may request a date-of-death valuation from the financial institution."

CWF Advises 8606 Notice be Given to Customers

Although it is not required, we at Collin W. Fritz and Associates also recommend, as a service to customers, a statement reminding them of their responsibility to file Form 8606 if they

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have made nondeductible contributions to their IRA(s). The Form 8606 must be filed with the customer's income tax return. Or, if no tax return must be filed for that year, the Form 8606 must be filed by itself by the tax filing deadline.

CWF's **recommended** additional language concerning Form 8606 reads:

"Be advised, that you must file the 1991 Form 8606 by April 15, 1992 (unless an extension applies) if: (1) you made nondeductible contributions to your IRA for 1991 (whether in 1991 or 1992); or (2) you received IRA distributions in 1991 and you have at any time (1987 - 1991) made nondeductible contributions to any of your IRAs. You will have to pay a $50 penalty for each failure to file the 1991 Form 8606, unless you can show that the failure was due to a reasonable cause."

"NEW" 1099-R

This form now serves the combined functions of the old 1099-R - used to report total distributions - and the old W-2P - used to report partial distributions. The new, single 1099-R reports both. Like its predecessor forms, it must be provided to customers by January 31st - in this case, of 1992. This date is important because information on the 1099-R may be needed in the preparation of the customer's taxes, if it reports distributions that must be included as taxable income. The 1099-R is not submitted to the IRS until February 28th.

The actual IRS form 1099-R may be used, or an institution may instead use a substitute which it generates itself, or purchases from a private supplier. The only stipulation is that this substitute must meet IRS specifications, as outlined in IRS Publication 1179.

If you do not provide your customer with the actual Copy B of the official IRS form, but instead use such a substitute, the form you use should have instructions similar to those on the back of the official IRS form, so that the information may be properly used by the recipient in completing their (or a decedent's) tax return.

Because completing the Form 1099-R is complicated, we suggest that IRA administration staff refer to IRS instructions on the Form 1099-R, or Collin W. Fritz and Associates' IRA Procedures Manual for step-by-step assistance.

Incorporating Special Required Information on Customer Statements

Incorporating required IRS terminology on customer statements may be more problematic than it first appears. With the automation of form and statement generating in many banks, this could pose difficulties in either programming, or having adequate space on printed forms.

1. The best course, if possible, is to have your data processing system programmed to print the information directly on the statement.

2. If this cannot be done, we recommend that a sticker containing exact wording be affixed to the statement.

3. Third alternative, and one the IRS might not be as approving of, would be to put the wording on an enclosure accompanying the customer statement. This approach would be our last choice.

Penalties for Late Filing, or for Failure to File

...with the IRS

Forms 1099-R, 5498

Internal Revenue Code section 6693(a) provides the authority for penalties for improper filing of these forms with the IRS for IRA purposes. That penalty is $50 per return per account, unless reasonable cause for such failure can be shown. Deadlines, again, are February 28 for the 1099-R, and on or before June 1 for the 5498. There is no maximum or ceiling on the penalties that may be assessed against a financial institution.

...with the accountholder

The same Code section (6693) provides the authority for penalties for failure to provide customers with statements at the appropriate time. Deadline for the January Statement is January 31, as it is also for the 1099-R.

If a copy of the 5498 information must be supplied to customers (if contributions were made in the year being reported) the deadline is May 31. For failure to provide these statements to the accountholder at the proper time, the penalty is $50 per infraction, unless there is reasonable cause.

IRA Rules on Enclosures With Statements

In addition to providing these reports on a timely basis and in an approved format, the IRS also requires that financial institutions meet certain rules on what materials may be included in such mailings.

...Non-IRA Forms ... A Comparison

Surprisingly, IRA statements actually have less demanding rules than some other financial institution reporting. Just to provide some perspective, consider certain forms used by financial institutions to report dividends and interest; Forms 1099-DIV, 1099-INT, 1099-PATR, and 1099-OID, reported under Code sections 6042, 6044, and 6049.

These non-IRA forms cannot be mailed with promotional material or other information on additional bank services or products. They can only be mailed with:

- 1098 or other 1099 forms; Forms W-8 or W-9

- a statement of the person's account as reflected on Form 1099

- a check - or a letter explaining the absence of a check

- a letter explaining the tax consequences of the information on the payee statement

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

...IRA Form/Statement Enclosures

Unlike the situation described above, the statement mailings for Forms 1099-R and 5498 are very liberal. To quote from the IRS instructions: "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 is very beneficial to financial institutions, which can maximize their resources by combining these key IRS statement mailings with either marketing or other administrative mailings.

In Future, More on 5498s

In a coming issue we will give further instructions on handling the reporting of IRS Form 5498.