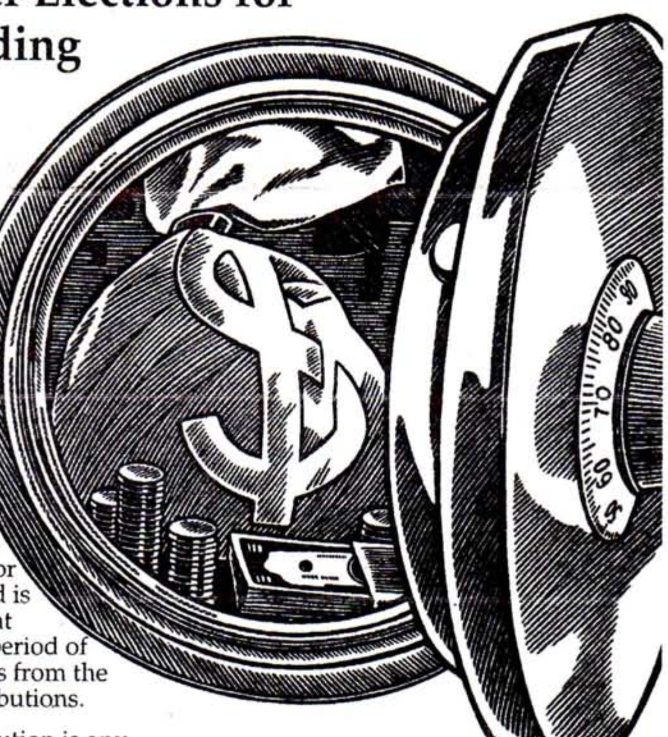
THE Pension Digest

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

IRA Withholding Notices and Waiver Elections for 70-1/2 Accountholders, and Withholding Rules in General



Since 1983 federal tax law has required an IRA custodian or trustee to withhold a portion of a distribution from an IRA unless the accountholder instructs the custodian in writing that he or she does not want any amount withheld. This article discusses the withholding rules for an IRA custodian, and is limited only to IRAs. The withholding rules which apply to distributions from qualified plans are similar, but are different in some important respects.

An IRA custodian has two separate withholding responsibilities. First, it must furnish in a timely fashion the prospective payee (accountholder or beneficiary) with a withholding notice. Second, it must determine what amount is to be withheld. In general, the rules governing when notice must be furnished and what amount must be withheld depend on the type of payment to be made.

What information must be in the withholding notice?

The payee must be told of his or her right to elect not to have withholding apply to any payment, and how one makes such an election. In addition, the payee must be told of his or her right to revoke the election and that such election stays in effect until revoked. And, the payee must be told that the estimated tax rules apply so that a penalty could be assessed if these estimated tax rules are not complied with.

Most IRA custodians use the IRS form W-4P (or a modified version of it as prepared by a pension consulting firm such as Collin W. Fritz & Associates, Ltd.) to handle the notice and election requirement. Many times it is also incorporated into a distribution form.

What types of IRA distributions are there for withholding purposes?

There are both periodic and non periodic distributions.

A periodic distribution is one which is includable in income for income tax purposes, and is received in installments at regular intervals over a period of more than twelve months from the starting date of the distributions.

A nonperiodic distribution is any distribution which is not a periodic distribution.

What amount must the IRA custodian withhold when it makes a periodic or nonperiodic IRA distribution, and there is no written instruction to not withhold?

A special rule exists for IRAs versus qualified plans. If an IRA is payable upon demand, then for purposes of calculating the amount to be withheld, a periodic distribution will deemed to be nonperiodic. This means the amount to be withheld is 10% of the distribution amount, unless the accountholder elects to have more withheld, or elects to have no withholding. If the IRA is not payable upon demand, then the IRA custodian must go to the wage tables to determine how much must be withheld, just as is required for any periodic distribution from a qualified plan.

The Rules as Applied to 70-1/2 or Older Accountholders

When an IRA accountholder reaches age 70-1/2 the rule is that he or she must make certain elections so that their required minimum distribution amount can be determined. The accountholder must also set up a distribution schedule (i.e. a periodic schedule of payments) which results in an amount being distributed to the accountholder equal to or greater than the calculated required minimum distribution amount.

When must the notice be provided to an IRA accountholder who is receiving a nonperiodic distribution?

The governing statute seems to require that the notice must be provided

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CWF to Offer IRA, Pension Advertising Assistance

Many financial institutions are presently not doing the retirement plan marketing they would like, due to expense, or simply the difficulty of finding a creative resource that understands pensions.

To better serve our Pension Digest subscribers, Collin W. Fritz and Associates, Ltd. has become a resource for print and broadcast advertising services, and point-of-purchase marketing items. A combination of writers, designers, and pension specialists on staff allows us to do this.

Initial offerings include the following ad themes:

- IRA, general
- IRA, special post-April 15th concept
- Simplified Employee Pension (group)
- Simplified Employee Pension (self-employed)
- 401(k) plans

Ads are offered with market-area-exclusivity, which will ensure no overlap of marketing messages between competing banks, but at rates far below traditional advertising agencies. Banks in any given market area will be served on a first-come basis.

Also available are statement stuffers, lobby and office easel displays, coordinated to the above pension themes. For more information call 1-800-346-3961. Ask for Mike Rahn in Marketing Services. PD

Excess Contributions — Or Are They?

Within the last four weeks we have become aware of the following situation that may present an IRA "administration problem" for the bank.

A Disallowed Deduction

The situation is this: a customer (i.e. a taxpayer) has received a letter from the IRS concerning their 1988 or 1989 tax return. The IRS has disallowed the IRA deduction which had been claimed because the taxpayer or his or her spouse was an active participant and their adjusted gross income was sufficiently high to disqualify them from all or a portion of their claimed IRA deduction. With the disallowance of the deduction, the IRS is asking for additional tax dollars plus accrued interest.

Example, George Gush and his wife, Anna, had a joint adjusted gross income of $85,000. Anna was an active participant in her employer's retirement plan. George had made an IRA contribution of $2,000 for 1988. Because they deducted the $2,000 on their joint income tax return, they paid $600 less in taxes than they otherwise would have. For whatever reason, they or their accountant did not apply the IRA deduction rules correctly. The IRS now requests to be paid the $600 plus the accrued interest. Therefore, George may need some cash to pay this tax bill.

Withdraw the money . . . ?

Should George withdraw the money from his IRA to pay this tax bill? Probably not, unless he has no other source of cash. The reasons are discussed below.

Excess — or Nondeductible Contribution?

Note that the IRS has disallowed the deduction, but the funds still sit within the IRA account. Must these contributions be classified as nondeductible contributions or can they be withdrawn as an excess contribution. Many accountants and customers say that the contribution would never have been made if it had been known that the contribution was not deductible.

The problem: many times the accountant of the customer will ask the bank to treat the withdrawal of the contribution in question as the withdrawal of an excess contribution. Is it?

The technical answer is "no." An excess contribution is an impermissible contribution — one which the person was ineligible to make. In the situation described above,the customer was eligible to make a nondeductible contribution, but made what he mistakenly thought was a deductible one.

The accountant will try to argue that the customer may withdraw this contribution as an excess contribution under the rules set forth in Code section 408(d)(5). This section allows the withdrawal of an excess after the due date for the applicable year's tax return. The accountant may even say that he or she has talked with an IRS agent and the agent said the funds could be withdrawn as an excess contribution.

The problem is that the IRS has not formally adopted this position in writing. The existing interpretation of the governing statute is that any amount withdrawn from an IRA which is not an excess is subject to being taxed under the pro rata taxation rules of section 219. That is, some portion of the distribution would be taxable and some portion would not be.

What difference does it make, and what should the IRA custodian do?

If the IRA custodian completes the Form 1099-R showing a reason code 8 in box 7, that tells the IRS that distribution in most cases is not taxable.

We do not recommend that the reason code 8 be used because of the partial taxability of the distribution. An IRA custodian should complete the Form 1099-R and use a reason code of 1 or 7 (depending on the age of the customer) and suggest that the customer or the accountant attach a note of explanation to their tax return if they feel that they should not be taxed on any portion of the distribution. At times like this the IRS may choose to be kind, when the statutory law would allow them to be otherwise.

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Excess—*Continued from page 2*

A different possibility would be that the IRA custodian use the reason code "8," but check the box "taxable amount not determined." We do not recommend this approach. PD

CAP Program for QP Defect Correction Made Permanent, Expanded

The IRS' pilot program for resolving qualified plan defects without resorting to plan disqualification (reported on in the October Pension Digest) has been both expanded and given permanent status, according to a recent IRS memorandum.

The Closing Agreement Pilot (CAP) program was initiated to help employers resolve certain form and functional plan defects at the key district level, without having to involve. the national office, and without the penalty of full retroactive disqualification sanctions. The CAP program was specifically meant for situations in which violations were unintentional and correctable, and sought to avoid penalizing plan participants for infractions beyond their control.

Under the CAP program, employers are required to correct past defects, ensure that these corrections are adhered to in the future, and pay a negotiated dollar sanction.

Initial application of CAP was limited to late amenders for TEFRA 1982, TRA 1984, REA 1984, operational top-heavy defects, partial termination cases, and cases involving the improper use of integration formulas. Certain other undefined issues could also be settled or "closed" with key district office discretion.

Wider CAP Scope

Now and in the future, all qualification issues may be handled under CAP except:

- repeated, deliberate and flagrant violations
- significant discrimination in favor of highly compensated employees
- exclusive benefit violations where asset diversion is involved
- plans with 500+ participants, or with $1,000,000 in potential tax liability PD

Marketing

Pension Products and Services

IRA Marketing Season About to Begin

There are certainly good reasons for financial institutions to maintain some kind of retirement plan marketing profile throughout the year.

But undeniably, the busiest time for IRA opening - and thus marketing for those accounts if you want them - is the period from the start of the new year to April 15th. This is the time of tax preparation. Even though it's easier to save IRA deposit money in smaller increments all year long, most people who use an IRA for tax advantages fund them in this narrow window of time.

How to Capture These Accounts

Just as there's no one prescription for every illness, there's no one prescription for IRA marketing success, That's impossible, because of variations in the nature and amount of competition, the local or regional media options available for sending your message, the workstyles and lifestyles of your market, and so on. But here are some basics that might help you distill the large volume of possibilities down to the concentrated essence of practical and effective options.

* Decide how much you want to take in in deposit dollars, to give yourself a goal to shoot for. Decide on a timetable, and chart your progress, enabling you to either maintain or revise your marketing approaches, at "halftime" instead of at the two-minute warning.

* Decide what you can afford to spend to get these deposits, both in marketing dollars spent, and in interest paid. But remember, by law you can't offer IRA accountholders incentives greater than those you're willing to offer to otherwise similar accounts.

* Take stock of your creative options. Do you have people on-staff who can create ads, brochures, mailers, etc.? Do you - or should you - work with a creative agency? Or must you rely on the local newspaper or radio station's advertising staff, or the instant printing firm down the street to create your "creative." Whatever the case may be, use the best creative help you can afford.

* If you're going after new IRA accounts in the open marketplace with other banks competing for the same dollars, accept the fact that your image has to be as professional and confidence-inspiring (remember, this is banking) as theirs. These qualities are not DETERMINED by your image, But to an unfamiliar buyer, they are PROJECTED, or PROMISED, by your image. First impressions carry great weight. If your competitor's ads attract attention, inspire confidence, and lead a prospect to the point of closing the sale, then yours must also.

* If you don't have a large staff with defined marketing responsibilities for projects like this, make sure you clearly assign coordinating responsibility. If possible, assign this to someone who has shown good marketing instincts, good organizational skills, and a desire to see your institution become more profitable. They'll be the most attuned to project needs and motivated to carry things out.

* Use every means possible to cross-sell a consistent message. This means staff in all departments should be briefed and able to recognize and refer a good IRA prospect to someone who can assist them.

It also means consistency in the images and messages that your marketing tools - ads, brochures, broadcast spots, signage, etc. - convey. If they're coordinated, the effect as a whole becomes greater than the sum of the parts. If they're not, the parts may compete, confuse, and neutralize one another.

Good luck! PD

to the payee at the actual time of the nonperiodic distribution. That is, the notice could not be given beforehand or afterward. The IRS thought distributees from a qualified plan should have some advance notice. So, the IRS modified the rule: the payee must receive the notice so that he or she has a reasonable time to elect to not have withholding apply and to reply to the plan administrator with the election information. However, with respect to IRAs, the IRS has stated the reasonable time requirement is met if the IRA custodian provides the notice at the time the accountholder requests a withdrawal from his or her IRA. As will be illustrated later, this "request at withdrawal" provision does not seem to apply to 70-1/2 or older accountholders who are receiving "deemed nonperiodic" distributions.

When must the notice be provided to an IRA accountholder (including one 70-1/2 or older) receiving a periodic distribution?

The answer depends on whether this is the first or a later distribution, and the frequency of the periodic distributions.

In the case of the first payment which is part of a series of periodic payments, notice of the election must be provided when making the first payment. However, because the IRS realizes that many IRA custodians and other payees use electronic funds transfer to deposit their checks, the IRS has ruled that the notice does not have to be attached physically to the check. It is sufficient to mail directly to the payee at the same time the check is issued if the payee receives the notice within 15 days before or after receipt of the first payment.However, the IRS would like to see the payee receive the notice immediately prior to or concurrent with the receipt of the check.

In the case of any later payment which is part of a series of periodic payments, the timing of the notice which is required depends on whether there are four (4) or more payments per year. If so, then, in lieu of providing a notice at the time of each distribution, the IRA custodian may furnish a blanket notice applicable to all such scheduled payments during the calendar year. Such a notice must be furnished at a reasonable time before the first payment to be made in the calendar year to which the notice relates.

Thus, those IRA accountholders who are receiving four or more payments per calendar year must only receive notice with the first distribution and then once a calendar year thereafter. The annual notice must be furnished before the first payment for that calendar year. The annual notice must be provided at approximately the same time each calendar year. That is, an IRA custodian could not furnish the annual notice on 1-1-84, 12-31-85 and 1-1-86 in an attempt to combine two notice periods. We would suggest sending with the January 31 Customer Statements.

In the every day world of IRA administration, however, there are many IRA accountholders who have set-up a regular payout schedule which only has one or two or three payments per year. This is very common for 70-1/2 accountholders who many times only have one payment per year. What are the notice requirements in this situation?

Assuming that the IRA is payable upon demand, the IRA custodian must treat these scheduled IRA payments as nonperiodic distributions. This means that the IRA custodian must furnish the payee the notice at the time of the distribution or at such earlier time as is provided in the regulations.

The regulation provides that the IRA custodian must furnish the notice not earlier than six (6) months before the distribution and not later than a reasonable time to elect to have no withholding apply.

Can the bank then send the 70-1/2 or older accountholder their one distribution check and send the withholding notice at the same time — presumably in the same envelope?

We would recommend that the notice be sent beforehand and that it not be enclosed in the same envelope containing the check. However, the governing regulation does not expressly address this question.

Since the one annual payment must be treated as a nonperiodic distribution, notice should be given beforehand and not at the time of the actual distribution. The IRS procedure would allow an IRA custodian to send out a notice on January 1st which would apply to all nonperiodic distributions from January 2nd to June 30th and a second notice on July 1st which would apply to all nonperiodic distributions from July 2nd to December 31st. Some IRA custodians include the withholding notice with their January customer statements. Note that there is no problem if the 70-1/2 or older customer comes into the institution to receive their distribution since the notice could be given to them at that time.

Once the IRA accountholder instructs the IRA custodian that he or she does not want withholding (i.e. waives it), that instruction may apply to any subsequent payment from the same IRA. However, the IRA custodian is still required to furnish the payee with the notice and revocation information and the information concerning possible liability under the estimated tax payment rules.

For example, CWF and Associates, Ltd. has designed their form #59 (Withholding Certificate for IRA Payments Payable Upon Demand and Annual Reminder Notice) to serve as this annual reminder notice. Based on the discussion from above, we would recommend that an IRA custodian furnish this form semi-annually or annually, as the case may be, to its 70-1/2 or older accountholders prior to the actual distribution. Although it is not required by the governing regulation, we believe the most conservative approach would be for the IRA custodian to furnish our form #59 or a similar reminder notice prior to the issuance of the check and have the customer sign it (and return it) each year showing the "no withholding" election. PD

Pension Digest Topical Index Available

An index to The Pension Digest spanning the period from March 1985 to the present is now available. Previously, a chronological index was available to subscribers. The new version is sorted by subject, making reference to various pension topic areas much easier.

Because of the size and comprehensiveness of this six-year index, a duplicating fee of $5.00 is being charged. Those who have paid for and received the earlier index will receive the new version free of charge.

For your copy, send $5.00 to cover duplication and handling to: The Pension Digest, Collin W. Fritz & Associations, Ltd., P.O. Box 426, Brainerd, MN 56501. PD