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Dividing Retirement Assets Adds to Divorce Woes . . . For Bank, Too

The division of property as a onsequence of a divorce or separation is at best a complicated matter. But dividing the furniture, personal possessions and bank account is simple compared to the handling of retirement plan assets.

Sooner or later your institution will be asked to either receive or disburse retirement plan assets. Besides not being an everyday transaction, it's one that can plunge your institution into some very hot water with the IRS or the divorced parties if done incorrectly.

Divorce and IRAs

While you may at some point find yourself helping to divide the assets of a qualified plan, the most likely situation you'll encounter will be one in which the assets of an IRA account at your institution are being divided by a divorcing — or already divorced — couple. Both IRAs may be remaining at your institution, or you may be transferring part of an account balance to another institution. Or, a third alternative, you may be the receiving institution, a role with comparatively less risk.

The Internal Revenue Code section hat applies is 408(d)(6), which allows ransfers incident to divorce or legal separation. These transfers are looked upon as a nontaxable transaction from the IRA of the accountholder to an IRA of the ex-partner.

In either case — divorce or separation — we recommend that the following procedures be followed in dividing an IRA account:

- Insist on being furnished a copy of the court order. This applies just as much to separation as to divorce. "Moving out" is not a separation in the eyes of the IRS. Be sure it's the final court order, with judge's signature and the court's seal.

- Be sure that the order identifies specific accounts, balances as of a given date, to and from whom funds are to be transferred, as well as where and when they are to be transferred.

- Assets ineligible to be transferred — such as minimum distributions or assets already subject to a prior court order — must not be transferred.

- If the transfer directive is not part of a comprehensive divorce or separation decree, don't honor it. A property settlement without a divorce or separation, is not sufficient authority for transferring IRA funds between individuals.

- Be sure to verify that the receiving individual has an IRA account to accept it. In order to ensure a proper transaction trail, it's advisable that the receiving IRA of the recipient spouse be located at the same institution as the original IRA. Once the fund transfer transaction has taken place, then the recipient spouse is free to transfer these funds to any institution he or she chooses.

If the funds are <u>not</u> to be transferred to the ex-spouse's IRA, then the agreement should be drafted to specify what funds are to be paid and to whom, and who is to bear the income tax consequences.

If you have advance warning — if your customer confides that an IRA asset split is imminent due to divorce or separation — suggest that his or her attorney try to influence the following

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Correction

In the February Pension Digest story "... Rules of IRA Advertising...," we erred in stating that an IRA cannot receive preferential treatment in interest earnings over other savings type accounts.

This is incorrect. If there is a linkage between an IRA and non-IRA account, as in a special marketing program, then you must treat an IRA just as you would another account (in a non-discriminatory fashion) in terms of interest or other benefit.

When there is no linkage, you may either offer preference to IRA accounts, or show preference to other accounts over IRAs.

We apologize for the error.

Editor

The Farmers & Fisherman's Tax Filing "Deadline;" Its Relationship to Plan Opening & Funding

In the evolution of our country's tax laws, certain regulations have developed that may appear unusual to the average taxpayer. An excellent example is the special tax payment and tax filing arrangement for farmers and commercial fishermen.

Unlike most self-employeds, who must estimate their federal taxes and pay them on a quarterly basis throughout the year to avoid tax underpayment penalties, farmers and commercial fishermen have another option. They may pay their taxes in just one payment, if they're willing to file their tax return by March 1 rather than the traditional April 15th date.

This arrangement most likely developed to allow for the seasonal nature of cash flow in these professions.

Is March 1st A "Deadline?"

It should be understood, however, that March 1st is not a true tax filing deadline. It is instead a "grace period" deadline that allows members of these groups to escape an underpayment penalty. Farmers and fishermen still have the option to pay by the April 15th date, if they've paid estimated taxes throughout the year, of if they're willing to pay any penalty that might be due for underpayment, which would be determined by the profitability of their business for that year.

When Must Their Retirement Plans Be Opened, Funded?

Because of the March 1st date for penalty-free tax filing, confusion has developed over plan opening and funding deadlines for these professions.

First of all, ***plan funding*** must be distinguished from ***plan opening,*** which varies by plan type.

. . . Plan Opening

To be able to make any contribution, a qualified plan (including one-person Keogh), must be opened by December 31st of the tax year. A SEP or IRA, however, can be opened until the tax filing deadline, usually the following April 15th.

. . . Must Filing, Funding Coincide?

The farmer or commercial fisherman who chooses to file their taxes by March 1 to avoid the tax underpayment penalty does not, as some suppose, have to fund their plan by that date. The confusion arises when this date is wrongly viewed as a tax filing deadline. As described earlier, it is really the end of a grace period, rather than a mandatory filing deadline.

Just as any farmer or fisherman could legitimately file up until April 15th, they may fund their Keogh, SEP, or IRA up until that time, or "plus extensions" in the case of the Keogh or SEP, even if they filed their tax return by March 1.

Amending To Take Advantage Still Possible

Any farmer or fisherman who has already filed their 1991 tax return may still take advantage of this later, traditional funding deadline. As outlined above, a new SEP or IRA could still even be opened. To do this simply requires filing an amended tax return that includes the appropriate contribution amount.

As a practical matter, if the taxpayer is expecting a refund, he or she should wait until that refund is received before filing the amended return. Otherwise the IRS may put the processing of their original return "on hold" until the amended return is processed, which could take up to several months. PD

Cautionary Comments On Death Benefit Exclusion Reporting

The Death Benefit Exclusion (DBE) is a valued tax "perk" given to beneficiaries of deceased qualified plan accountholders. It allows them to receive up to $5,000 tax free from lump sum qualified plan distributions, which can have a significant impact on their tax liability.

But reporting such a distribution properly is not as easy as it should be, thanks in great part to vagueness in IRS instructions.

The instrument for this reporting is of course the distribution Form 1099-R. The confusion lies in how to complete two of the three boxes that must be filled out. The boxes are:

Box #1 — gross amount of distribution

Box #2 — taxable amount of distribution

Box #7 — reason code

Box #7 is easy. Death is the reason for distribution. If only 5/10 year-averaging applies, item 4a is checked. If only the DBE applies, it's item 4b. If both apply, it's 4c.

So let's assume, for our case, we check item 4b, DBE only.

But what do we enter for the gross amount of distribution — Box #1 — and the taxable amount — Box #2 — of distribution? For illustration purposes, let's use an example of a $30,000 lump sum qualified plan distribution, eligible for a $5,000 DBE.

In a number of past instances in which monies are excluded from taxability, IRS rules seem written in such a way that the agency appears to not want to know about non-taxable amounts. If that is the case, we might report both Box #1 and Box #2 as $25,000, the amount taxable after allowing for the $5,000 DBE.

But in some recent rulings and opinions, the IRS seems to be slowly gravitating toward the opposite pole, to wanting both gross amounts and taxable amounts. In that case, we would report Box #1 as $30,000 gross distribution, and $25,000 as taxable, after allowing for the $5,000 DBE.

A third and further confusing option would be to report the $30,000 amount in both Box #1 (gross) and Box #2 (taxable). This would mean relying on Box #7, item 4b. ("Death Benefit Exclusion applies") to clue the IRS in as to why only $25,000 of this distribution finds its way into the taxable income calculations of this individual's tax return.

Unfortunately, the IRS gives no guidance as to which approach it wants for the preparation of the 1099-R for those

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receiving a distribution qualifying for DBE treatment.

However, in practical day-to-day pension plan administration and reporting, decisions have to be made despite a lack of full and understandable guidance. This is where judgment and experience come in.

We generally recommend one of two options in such a situation, in our order of preference.

1. Report gross income (Box #1) as $30,000, and taxable income (Box #2) as $25,000. Or,

2. Report both Box #1 and #2 as $25,000 on the premise that — as so often seems evident in past IRS opinions — the agency is not terribly concerned with nontaxable income.

We would steer clear of reporting both Box #1 and #2 as $30,000, which could very possibly lead to a "red flag," and an audit of this individual's tax return. That's something everyone would just as soon avoid. PD

Schedule P Filing Reminder

Schedule P is one of several important schedules filed with the annual returns of pension benefit plans. Its purpose is to set in motion the statute of limitations for information filed on Forms 5500, 5500-C/R, and 5500EZ.

Schedule P may be filed by any trustee of a trust created as part of an employee benefit plan as described in section 401(a), or any custodian of a custodial account as described in section 401(f). It is NOT to be filed by itself, but only as an attachment to one of the three previously described forms.

Sample Enclosed For Your Convenience

Schedule P is an IRS form which is normally available to your institution free of charge from that agency. For your convenience, however, a sample of the most current version has been enclosed with this month's Pension Digest and may be photocopied for your use.

(An in-depth discussion of the use of Schedule P was published in the February, 1991 Pension Digest. If you were not a subscriber at that time, please contact us for a copy, provided for a minimal postage/reproduction charge, at 1-800-346-3961.) PD

Marketing

Pension Products and Services

Low Interest Rates A Good Reason To Offer Self-Directed IRAs

There are a number of telltale events that occur when interest rates drop drastically in financial markets. One is the rush of people to refinance loans made at higher rates. Home mortgages are a prime example. Another is the flight of savings dollars from traditional guaranteed-return savings instruments, such as CDs, to other instruments that seem to offer more growth potential.

This is as true of IRA accounts as it is of other demand-type savings accounts. Where is the money going? It's searching for a home where its earnings may be substantially higher than in a CD, many of which are now offering a return of 4%, or less.

Can these IRA funds find such a home right there in the same financial institution? The answer is usually "yes." In many cases, however, these funds are going to the brokerage houses instead.

Who's Leaving?

It's not just the most sophisticated investor who's walking across the street to these firms. The faithful departed include a surprising number of very average people, who — armed with the names of some recommended and relatively safe mutual funds — are deciding to live with a certain amount of risk in their IRA in exchange for the prospect of doing much better than just keeping abreast of inflation with CDs.

Some are directing investments into stocks, bonds and money market funds independent of any mutual fund. But these are usually the more sophisticated, experienced investors. Mutual funds are still especially popular.

What Can Banks Do To Combat IRA Fund Flight?

This IRA money doesn't have to leave the bank, if the institution offers a self-directed IRA option. For many years, most financial institutions were prohibited from offering securities by legislation like the Glass-Steagall Act. But under today's banking regulations, nearly any IRA sponsor can find a way to offer self-directed IRA accounts. This is typically done in affiliation with a brokerage house. Or it may be done via the trust side of an institution, if it has trust powers.

What Is A True "Self-Directed" IRA?

In pension terminology, a self-directed account is one in which investments are made by the institution at the accountholder's direction, into investment instruments other than time deposits. While it's true that a customer may "direct" a bank to invest in a specific CD instrument under a purely custodial IRA plan, this is not considered a true self-directed account.

A Different Plan Agreement

The IRA plan agreement document for a self-directed account is somewhat different from that for a regular custodial IRA. Make sure you use the proper type plan agreement. Among its differences is the fact that no earnings projection is usually made under the disclosure section of the plan agreement, if the account assets are being directed by the accountholder into investments other than assured-interest time deposits. If the initial investments in a self-directed account are time deposits, however, we recommend that an earnings projection be made.

Risk Tailored To Your Customer's Comfort Zone

Acknowledging that mutual funds are a logical "next step" for the IRA accountholder who wants to move from the purely custodial account to a self-directed IRA, there are a variety of mixtures of stocks and bonds in these mutual funds, some even including a percentage invested in a money market fund, or bank CDs, for some element of guarantee. It seems that no matter what level of risk a customer is comfortable with, there's a mix designed to match that comfort level.

If you're seeing IRA dollars leave your institution, or not enter at the rate you feel they should, consider the self-directed IRA option if you don't already have it. And promote it vigorously if you do. PD

Dividing Assets—*Continued from page 1*

or similar language be included in the final decree:

It is hereby ordered that ______ (spouse #1) shall transfer $______ from his or her IRA to the IRA of ______ (spouse #2). This transfer shall be made on or before ______ and shall be made pursuant to Internal Revenue Code section 408(d)(6). The amount to be transferred shall be the amount which remains after the assessment of any penalty for the early surrender of a time deposit. Once the funds are transferred, they will be IRA funds of spouse #2, subject to all applicable IRA rules.

Divorce and Qualified Plan-To-IRA "Transfers"

This transaction is a rarity compared to divorce-initiated IRA-to-IRA transfers.

QPs Once Difficult to Crack

Qualified plans historically were safer from divorce/separation property settlements. The protective language stating that such plan assets could neither be assigned nor attached were upheld much more vigorously than IRA protections. For a time there was a great deal of litigation aimed at tapping qualified plan accounts as part of property settlements.

State courts would typically include QP account balances in settlements, to be usually followed by federal court rulings to the contrary. Finally Congress got tired of the see-saw of litigation, and took action under IR Code section 414(p). This brought forth the Qualified Domestic Relations Order, known as the QDRO or "Quadro" in pension jargon.

Be aware that a QDRO has nothing at all to do with the division of IRA assets. It applies solely to the direction of Qualified Plan assets, and involves an IRA only as a receiving vehicle for the tapped funds. This is important to remember both when analyzing a court order (must be a QUALIFIED domestic relations order), or when providing guidance to a customer and/or their attorney(s) during the Order drafting process.

Receiving vs. Disbursing Pursuant to a QDRO

For most of our readers, their only involvement with a QDRO-mandated qualified plan distribution will be as the receiving institution when these funds are rolled over into a customer's (as alternate payee) account. In that circumstance, all they need do is be sure that their customer signs a rollover certification. The only time an institution will find itself disbursing will be if it was acting as trustee for a Qualified Plan now being tapped by a QDRO.

If this is the case, caution is the first order of business. It is the plan administrator's responsibility to determine if it is indeed a legitimate Qualified Domestic Relations Order, before any payment is made from the plan to the spouse.

We further recommend that the person handling this transaction for the financial institution be a person with supervisory experience and authority, rather than someone with less experience. There is very real liability in this transaction, and it is also advisable to consult a tax attorney, perhaps the bank's own legal counsel. PD

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Question: If an individual decides to withdraw funds from their IRA before age 59-1/2 and sets up a series of substantially equal periodic payments, can they still contribute to their IRA? If so, must their payments be calculated to include these new contributions?

✓ Answer. The IRS has written very little on the subject of substantially equal periodic payments. The main writing on this subject was in Notice 89-25. Therein, the IRS gave three payment methods which they said would qualify as "substantially equal periodic payments."

The three methods were: (1) the 401(a)(9) method — in plain English, this is the formula used for 70-1/2-and-over distributions: (2) an amortization method; and (3) an annuity factor method.

To the best of our knowledge the IRS has never addressed the question of how subsequent contributions affect the substantially equal periodic payment schedule, if at all.

We believe that additional contributions should not be made to an IRA if the substantially equal periodic payments are determined under either the amortization or annuity factor methods. The reason is that payment amounts calculated under both of these methods are FIXED, not variable. Any additional contributions would have to remain in the account, not calculated into the periodic payment schedule.

There would be no vehicle for distributing these funds unless the payment schedule were altered, and this could not be done for five years, or until the accountholder attained age 59-1/2, whichever is later.

In contrast, the 70-1/2 method is based on the December 31st balance. Therefore, additional contributions would increase the balance and allow an additional amount to be paid out.

However, since the IRS has not ruled on this specific issue, the conservative approach would be to not make additional contributions. 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.

Offering SEP Option Can Be As Simple As You Wish

Many financial institutions are apprehensive about offering a Simplified Employee Pension (SEP) to customers, fearing that inevitably they must take on major administrative responsibilities, and their potential liability.

This is **not** true. A bank can provide its business customers a SEP pension option — using either the IRS Form 5305-SEP or a private SEP prototype — and have all administrative duties performed by that business, or by their accountant or other tax advisor.

But if this is the case, it should be spelled out in a signed service agreement. Collin W. Fritz and Associates provides service agreements for use with either the IRS form 5305-SEP or our own SEP prototype.

A sample copy is enclosed. A master copy for reproduction purposes is available for $15.00 and may be ordered by phone, 1-800-346-3961, or (FAX) 218-828-3589. PD