THE Pension Digest

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New Law Includes 20% Withholding Rule on QP Distributions

Tacked onto a recent bill authorizing the extension of jobless benefits, was a provision dealing with withholding on distributions from qualified plans. (The new law does not deal with payments from IRAs.) These new rules go into effect for distributions on or after 1-1-93. They do not apply to distributions in 1992.

New Rule #1: If the proposed distribution to a QP participant would qualify for rollover treatment to another QP or an IRA, then a participant will have the option of either (1) having the funds "transferred" directly to the trustee of a new employer's QP, or to an IRA plan, or (2) having the funds paid to him or her, but with the trustee required by law to withhold 20% of the amount to be distributed to satisfy potential taxes on the distribution.

New Rule #2: Any portion of a plan distribution — whether lump sum or partial — qualifies for rollover/transfer to an IRA, or to another employer's qualified plan, unless the distribution was one of a series of payments over single or joint life expectancy, or over a specified period of 10 years or more.

Plan administrators of QP plans will be required to present these two options to participants prior to distribution being made.

Some newspaper articles and commentaries on this new law have taken the position that it is a change for the better since it allows QP participants to directly transfer their funds to an IRA.

However, this ability to transfer funds existed prior to the law change. The RMD regulations written in July of 1987 authorized such transfers from QP plans directly to IRAs (reporting was, however, handled like a rollover). Admittedly, the new law makes such transfers mandatory on the part of the plan if the participant elects this transfer. QP administrators cannot balk at such requests as they sometimes have since 1987, since the authority for such transfers was previously only a proposed regulation, and not a law.

We perceive that the unstated reason for the law change was that the IRS was having problems collecting taxes owing from such QP distributions.

Many people are being terminated from their employment. Under current law they are being paid their accrued pension benefits, and many are not rolling over such funds. This means that they must pay taxes on the distributions. In general, such a person would fall into one of the following categories:

1. The person would pay 15% of the amount distributed as taxes if their marginal rate is 15% and the person is age 59-1/2 or over; or

2. The person would pay 25% of the amount distributed as taxes if their marginal rate is 15%, but the person is not yet age 59-1/2 and no other exceptions to the pre-59-1/2 10% excise tax apply.

3. The person would pay 28% of the amount distributed as taxes if their marginal rate is 28%, and the person is age 59-1/2 or over;

4. The person would pay 38% of the amount distributed as taxes if their marginal rate is 28%, but the person is not yet age 59-1/2, and pays the 10% excise tax.

If a terminated employee/pension recipient did not have knowledge of the rules, he or she could certainly be in for an unpleasant tax lesson when tax time comes.

An Example Under Current Law

For example, assume a terminated employee was paid $16,000 (his vested account from his 401(k) plan) in June of 1991, and he was only 41. He elected to have no withholding. He did not rollover the funds because he was unsure of his employment prospects. He spent the entire $16,000 on various loans or credit card balances which he had outstanding,understandable if one is unemployed.

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Also In This Issue —

Revenue Procedure 92-38 Update

In the June issue of The Pension Digest, we discussed IRS Revenue Procedure 92-38, which requires amending of prototype IRAs by May 18, 1993, and also served notice that all non-prototype IRAs can be expected to require amending at an undermined point in the future.

Of greatest interest to most financial institutions is the latter item, because most IRA plans are based on the IRS model forms, not prototypes.

Since that time we have again been in contact with the IRS representative charged with making the changes to the IRA model forms. She informed us that a draft of the changes was submitted, but was not approved. In her opinion, it now could easily be year's-end before the new model form language is approved.

As noted in the June Pension Digest, it is very likely that the IRS will grant its traditional grace period for amending once the new form language is approved. In the past, this has often been a one-year period.

We will keep you updated on this important issue on a regular basis. PD

Keogh/QP Plan Transfers: Caution Advised

With falling interest rates, many long-time Keogh accountholders are transferring their Keogh assets to brokerage funds and guaranteed annuity contracts with insurance companies.

Unfortunately Keogh funds are NOT as readily transferable as IRA funds, but most Keogh accountholders do not know this. Technically, your customers/accountholders may be putting all of their Keogh funds at risk of adverse tax consequences.

Why? A Keogh plan (even for a single participant) is a pension plan. The pension plan document controls when distributions are permissible. In contrast to IRA documents which allow for distributions at any time, Keogh plan documents normally only permit withdrawals at (1) termination of employment, (2) 59 1/2 or older (i.e. the person has reached the normal retirement age) or (3) upon plan termination. The QP prototypes written by Collin W. Fritz and Associates, Ltd. for example, contain such provisions. Some plan documents may be even more restrictive and may not permit distributions until age 65 or plan termination. Self-employed individuals cannot terminate employment, thus they would have to reach age 59-1/2, or 65, as the case may be, or terminate the plan.

Thus, Keogh accountholders under age 59-1/2 will be eligible to transfer their funds only if they terminate the entire plan. This means that they do not have the option of transferring those CDs which have matured, and retaining others until they mature.

It may be a technicality, but the IRS' longstanding rule is that a plan must be administered as the plan document is written. The IRS has said that plan disqualification is the consequence for violating this rule, which leads to numerous adverse tax consequences. If your bank is the custodian or trustee of such Keogh funds, you want to avoid participating in any improper transfers that might allow the customer to claim that you should have known better, and that you should share in their tax problems.

Note that if your Keogh accountholder is over 59-1/2, he or she may choose to transfer only a portion of his or her account balance. Assuming the plan document would permit him or her to take a distribution, he or she also has the right to transfer the funds.

You can certainly expect some customer dissatisfaction and grumbling as to why you will not permit partial transfers in the pre-59 1/2 period. But you are required to do it. If the customer doesn't believe you, they have the option to substitute themselves as the Keogh custodian/trustee, and could then make the transaction at their own risk. But in the interest of good customer service, you want to help that customer avoid making a major tax blunder.

Our advice to those Keogh accountholders who are being told by brokerage firms that there is "no problem" with partial transfers is, "get it in writing." They may then have some recourse in future litigation if they have relied on their (supposedly) qualified advice.

Other Considerations in Transferring Keogh Funds:

1. As with IRAs, a required minimum distribution (70-1/2 and older) should not be transferred. Technically, the 50% excise tax will apply to any RMD which is mistakenly transferred.

2. The survivor benefit rules apply to some qualified plans: all money purchase plans, all defined benefit plans and some profit sharing plans. If your Keogh accountholder is transferring funds from a money purchase plan to a profit sharing plan, we would strongly recommend that before transferring the funds you have the new custodian/trustee certify that it understands that these transferred funds are subject to the survivor benefit rules. PD

Revenue Ruling 92-47

... "income in respect of a decedent" rules DO apply to IRAs

In recently issued Revenue Ruling 92-47, the IRS discussed a number of income tax issues that arise when IRA funds are paid to a decedent.

The main focus of the Ruling affirms that the "income in respect of a decedent" rules DO APPLY to distributions to beneficiaries of IRA accounts.

Simply put, "income in respect of a decedent," or IRD, is income to which the decedent was entitled, but had not yet received prior to his or her death. This would include accrued dividends, interest on stocks and bonds, employment benefits, etc. Since most taxpayers pay taxes on a "cash basis" and this income was not actually received, it is not taxable income to the decedent on his or her final tax return.

Illustration

An accountholder died, and his IRA funds were paid to his beneficiary (a child) in lump sum shortly after the accountholder's death.

The funds in the IRA were from several sources:

1) deductible contributions by the accountholder

2) realized and unrealized earnings (appreciation in asset value) owing to the deductible contributions up to the time of death.

3) nondeductible contributions by the accountholder

4) realized and unrealized earnings (appreciation in asset value) owing to the nondeductible contributions before the time of death

5) realized and unrealized earnings after the time of death

The IRS ruled that "income in respect of a decedent" in this case was: that portion of the lump sum distribution that equaled the IRA's fair market value (FMV) at the time of death, less the accountholder's nondeductible basis (items 1), 2) and 4)).

Gross taxable income to the child beneficiary would be this same portion — the IRD — plus income earned by the IRA from the time of death to the time of distribution (items 1), 2), 4) and 5)).

An Important Deduction

The beneficiary in this case was also entitled to a tax deduction equal to the amount of the estate tax that would apply to the amount of the IRD. Otherwise the beneficiary would be taxed doubly on the same funds.

We suspect that some IRA accountholders have been missing this special deduction, which is there for the taking, and should be taken advantage of. PD

Compliance Reminder: Use Proper IRA Projection Schedules

Because of a number of IRA projection schedule problems encountered recently, we are offering this brief reminder. When an IRA is established, IRA projections must use an interest rate equal to or less than the rate being offered to that particular IRA customer.

This means that if your IRA forms contain projection charts using an interest rate of 4% (or greater) and you are now paying less than 4%, you must make some changes so that you comply with this rule. The IRS fine for using noncomplying interest rates to generate projections is $50 per affected accountholder. Possible ways of complying are: (1) purchase and use forms that contain projection schedules with 2% (or other rate lower than currently offered); and (2) purchase and use a special insert page which contains the projections at the lower percentage rate.

Please contact Collin W. Fritz and Associates, Ltd. if you need further assistance. 1-800-346-3961 PD

Reminder: Be Watchful for Prohibited Transaction Possibilities

As interest rates drop, IRA and Keogh accountholders are starting to think more "creatively" about investing their IRA or Keogh funds.

Some creative investments may well be permissible, but many may not be. You as the IRA custodian/trustee must be vigilant for IRA transactions that will or may be prohibited transactions as defined in Code section 4975.

Prior newsletter articles (November, 1990) have discussed this subject in detail. The basic concept is quite simple: the IRA cannot "do business" with the trustee bank, the IRA accountholder, or anyone closely associated with the accountholder.

When in doubt, call your bank's counsel or your tax consultant. The tax consequences are extremely harsh for IRAs: the account is considered distributed as of the first day of that tax year.

It is too late to call after the prohibited transaction has occurred. The DOL will almost never grant retroactive exemptions, especially for IRAs. PD

Supreme Court Upholds ERISA in QP Bankruptcy Protection Decision

Multiple Participant Plans

It took the legal system eight years, but the United States Supreme Court on June 10th, 1992 resolved the major issue of whether or not a bankruptcy trustee could seize a debtor's qualified plan assets. (John R. Patterson v. Joseph B. Shumate, Jr.).

This case dealt with the interrelationship of the Bankruptcy Code and ERISA, The Employee Retirement Income Security Act.

ERISA contains express provisions stating that pension funds are not subject to the reach of creditors, with very few exceptions. The public policy of federal law is that these funds will be used for retirement purposes.

Federal bankruptcy law in section 541 accommodates the old common trust law rule that a grantor of a trust may establish a beneficial interest for a person and place restrictions on it so that the creditors of that person may not reach these assets. Thus, the bankruptcy code recognizes the trust law position that such restricted assets do not really belong to the debtor and therefore will be excluded from the bankruptcy estate. In plain english, this means that the assets are not available to be distributed to the creditors because they don't really belong to the debtor.

Prior to the Supreme Court's decision, the majority rule adopted by most federal courts was that a bankruptcy trustee could normally take the account balance of the debtor/participant to pay off the debts of the debtor. They further ruled that only state law was to be used to determine if the funds could be excluded. These courts ruled that the only way the funds could be exempted was if the debtor's interest in the plan qualified as a spendthrift trust under applicable state law. These courts would use almost any "access right" of the debtor to justify a finding that there was no spendthrift trust.

A minority of federal courts, however, had concluded that a debtor's interest in a qualified plan could not be reached by the bankruptcy trustee.

The Supreme Court has now vindicated the minority position as being the correct one.

Justice Blackmun delivered the opinion for a unanimous Court. The Court had to decide whether an anti-alienation provision contained in an ERISA-qualified pension plan constituted a restriction on transfer enforceable under "applicable nonbankruptcy law" and whether accordingly, a debtor may exclude his interest in such a plan from the property of the bankruptcy estate.

The debtor had been president of a furniture corporation which was liquidated under Chapter 7 of the Bankruptcy Code. He had also filed his personal petition for bankruptcy. With his filing, he had claimed that his $250,000 account balance in the pension plan was excludable from the estate. The District Court had ruled that the bankruptcy trustee could seize the $250,000.

The Supreme Court ruled that the plain language of the Bankruptcy Code and ERISA determines this case. The natural reading of the Bankruptcy code entitles a debtor to exclude from property of the estate any interest in a plan or trust that contains a transfer restriction under any relevant nonbankruptcy law. Nothing in section 541 of the Bankruptcy Code suggests that nonbankruptcy law means only state law, and not federal law. Or more specifically, the anti-alienation provisions of ERISA. Thus, the debtor could legally exclude the $250,000.

Besides the specific case ruling, this case is of importance because the Court to a certain degree chides the lower courts for not reaching a result that seemed obvious to the Supreme Court.

However, the fact that the lower courts reached the verdicts they did is not all that surprising. Courts, like individuals, do not like to be told that they don't have the authority they desire.

Within this decision there was no discussion of how this case affected previously decided cases that had allowed the bankruptcy trustee to take contested funds. Those prior decisions are apparently final unless an appeal is still in process.

Does This Apply To One-Participant Plans?

The Patterson v. Shumate case cited above does not specifically address the question of whether a participant in a one person plan would be entitled to exclude the assets in his or her plan from the bankruptcy estate or trustee. We would conclude that they would be entitled to exclusion.

The Supreme Court concluded that "applicable nonbankruptcy law" encompasses federal law. Federal tax law clearly requires a one person plan to have the same anti-alienation provisions and protection as a multiple participant plan.

The approach of this Supreme Court decision seems to be to require Congress to write the laws clearly. If Congress would prefer another result, the law must be written that way. The Supreme Court does not appear willing to rewrite the laws. PD

Violating the Once a Rule Year IRA Rollover ~~Year~~

IRA accountholders do err from time to time. But some errors are more painful than others. According to the Internal Revenue Code, an IRA accountholder is permitted only one rollover per 12-month period. The U.S. Tax Court in Marshall Martin V. IRS (June 1992) recently had to determine if a recipient of a distribution from an IRA should be taxed because he was not eligible to roll over that distribution, having already used up his right to one rollover distribution per year.

Case Facts & Time Sequence

1. On 2-5-87, the accountholder requested a check for his entire account balance of $111,615.57 from brokerage firm #1.

2. That same day (2-5-87), he deposited the $111,615.57 into an existing IRA with brokerage firm #2.

3. On 5-8-87 he withdrew $164,596.13 from this IRA (brokerage firm #2).

4. On 7-7-87 he contributed $120,000 from a third plan as a rollover contribution to this IRA.

5. On 9-3-87, he withdrew $10,000 which he did not recontribute.

Which of these distributions should be considered taxable?

The Arguments

The accountholder/taxpayer had argued that the first distribution had really been a transfer rather than a rollover, inasmuch as the entire amount of the distribution from IRA #1 was deposited into IRA #2 on the same day.

The court ruled otherwise, and found that all distributions after the first distribution should be taxed. The check received by the accountholder was in itself proof that this individual had "dominion and control" over these funds. This is a characteristic of a rollover, whereas a transfer goes directly from account-to-account, from institution-to-institution.

Revenue Procedure 92-46: Magnetic Media

The IRS has recently issued its Revenue Procedure 92-46 for filing Forms 5498 and 1099-R and the other 1099 forms on magnetic media. These are the rules which will govern the filing of the 1992 forms to be filed in 1993. You may obtain a copy from Collin W. Fritz and Associates, Ltd., by sending a check for $6.00 to P.O. Box 426, Brainerd, MN 56401.

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Question: Our bank is starting to receive more and more divorce decrees purporting to transfer the IRA account(s) of one spouse to the other, former spouse. The court decrees use the term Qualified Domestic Relations Order, and the acronym QDRO. What is a QDRO and do they govern IRAs?

✓ Answer. A QDRO is a Qualified Domestic Relations Order.

Technically, this term applies only to funds in qualified plans, not funds in IRAs. This does not mean a court cannot divide IRA assets between spouses, but the very strict QDRO rules do not apply to IRAs. However, many attorneys and judges do not realize that IRAs are not subject to the QDRO rules.

If you do not feel the court order is adequately clear as to what is expected of the IRA custodian, you should contact your bank's legal counsel for advice.

As a general rule, you should do only what the court order authorizes or instructs you to do. Do not consent to changes that the parties wish to make without court supervision.

Question: My bank had an IRA accountholder furnish us with her written request to transfer all of her IRA funds to a new IRA custodian. We had also received a transfer form from the new IRA custodian. The accountholder died before we transferred the funds. What should we do?

✓ Answer. We would suggest that you check with the new custodian to see who the beneficiary was under that new IRA.

If the beneficiary was the same person under both the old and the new IRA, then you could transfer the IRA funds as long as the new custodian certified that he or she knew these IRA funds were inherited IRA funds, and that they would administer the death payout elections and rules.

If the beneficiaries were different, then you should discuss this situation immediately with your institution's attorney before transferring the funds.

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.

20% Withholding—*Continued from page 1*

He went to his accountant on 4-4-92. The accountant informed him that he owed the IRS 25% (15% marginal tax rate, plus 10% penalty) of the $16,000 as taxes, or $4,000. If he had been in the 28% marginal bracket, he would have owed $6,080.

Most people would have great difficulty producing this amount for payment at tax time.

This is just what the IRS apparently hopes to avoid with the new rules.

10-Year Averaging No Longer Available

As you may recall, Congress — after being guided by the tax professionals on the various tax committees — rescinded the right to 10-year-average for those individuals who receive lump sum distributions prior to age 59-1/2, regardless of whether the terminating participant had a choice in the situation.

Might Pre-59-1/2 Excise Tax Increase?

Note that the new law only deals with increasing the amount of withholding to 20%, and making withholding mandatory. This new law does not change the amount of the excise tax for receiving distributions prior to age 59-1/2. It remains at 10%. An increase in the excise tax from 10% to 20% or higher is certainly possible in the future, as IRS personnel and Congressional aides reportedly feel that something must be done to achieve the result of having a larger number of recipients rollover their distributions.

In summary, commencing 1-1-93 distributions from qualified plans will be subject to mandatory withholding at the rate of 20%, unless a transfer is elected. The mandatory withholding will make it much easier for the IRS to collect the taxes due from such distributions. Qualified plan administrators will be required to inform participants of these new rules. CWF and Associates, Ltd. will of course be designing a new form to handle these new rules.