THE Pension Digest

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Withholding, Rollovers & Transfers ... A Comparison of Old & New Rules

On January 1, 1993 new rollover, transfer and withholding rules go into effect for those situations in which a participant is entitled to be paid funds from a qualified plan or a 403(b) annuity or a 403(a) annuity.

The new rules do not apply to distributions from IRAs. The new rules will impact the number of rollover contributions being made to IRAs (should decrease dramatically) and the number of transfers being made to IRAs from qualified plans (should increase dramatically).

For purposes of this article, those rules which expire as of December 31, 1992 are called "old law," those which apply on or after January 1, 1993 are called "new law."

What is the impact of these changes? While prior editions of this newsletter have discussed many of the changes, this article provides a more detailed summary.

Changes to Forms

The changes will require that you begin using revised IRA and QP forms:

1. Rollover Certification Form
2. Distribution From Qualified Plans Form
3. Transfer From Qualified Plans Form
4. IRA Disclosure Statements
5. Withholding Forms - IRS Form W-4P and any which incorporate its provisions.

Changes to QP Prototypes

Changes will also need to be made in qualified plan documents. The IRS has not yet set a deadline for these changes. The IRS will need to do something soon since to remain "qualified" the QP document must authorize the special IRA transfer as

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Also In This Issue —

Bank Staff IRA Education Now Critically Important

Now more than at any time in recent years, retirement plan administration is changing. New IRA plan language will soon be released, and will require amendment of all IRA plans. There are also critical new rules on withholding from QP distributions that are to be rolled over to IRAs, as well as new rules on IRA revocation and more.

Now is therefore the time to consider IRA training updates for your staff, both on introductory and advanced levels. For information on upcoming programs, contact Collin W. Fritz & Associates at 1-800-346-3961, or your state banking association.

It's Official — Truth-in-Savings Act Adopted — IRAs Affected

The long-awaited, much-dreaded Truth-in-Savings Act has now officially been adopted, as of September 19. Its implications for IRAs, as well as other savings products, will be felt in the coming months as the March 21 deadline for mandatory compliance nears.

The Federal Reserve Board vote on TISA was a fitting 3-2 verdict; fitting because there has been much outcry against its implementation during the public comment period. FRB Governor John LaWare was one of those in opposition, calling TISA unnecessary, stating that it will add "massive additional costs and regulatory burdens," and contending that there have not been excessive problems in the area of deposit account disclosures. The other individual voting against adoption of TISA was David Mullins, Vice Chairman of the Board.

The final version of Regulation DD has just been published in the Federal Register. While many of its provisions mirror the original version, the Board has made some changes to the proposed rules based on over 1,400 letters of comment.

Does Truth-in-Savings Act Apply to IRAs?

Because the final version of Regulation DD was not explicitly clear in its answering this question, we contacted and questioned a representative of the Federal Reserve on its application to retirement plans. This is their response:

1. TISA definitely applies to "regular" IRAs invested in time deposit savings instruments.
2. TISA does not apply to IRA investments other than time-deposit instruments (as found in self-directed IRAs).
3. SEPs and qualified plans are not covered by TISA rules.

We will continue to keep you informed on TISA matters in upcoming issues.

Non-Discrimination Reg. Effective Dates Moved...Again

The IRS and the Treasury Department have announced the postponement of the effective dates of certain provisions of the final regulations on pension plan non-discrimination, as well as the Code section 401(b) remedial amendment period, and transitional relief provisions found in Notice 91-38.

Final Regulation Effective Dates

The effective dates of the final regulations had earlier been extended to the first day of plan years beginning on or after January 1, 1993. However, this deadline has been replaced by the following effective dates:

1. The final regulations for plans governed by Code sections 401(a)(4), 401(a)(5), 401(a)(17), 401(1), 410(b) and 414(s) - first issued on September 19, 1991 - will be effective the first day of plan years beginning on or after January 1, 1994.

This is a full one-year extension.

2. Tax-exempt organization plans' effective date would be the first day of plan years beginning on or after January 1, 1996. (Note that such a tax-exempt organization plan is one that benefits employees, and in which 50% or more are employees of the specific tax-exempt organization.)

3. For government plans governed by Code section 414(d), those nondiscrimination regulations that apply, including Code sections 401(a)(26), 401(k) and 401(m), would be satisfied until the first day of plan years beginning on or after January 1, 1996, or 90 days following the opening of the first legislative session on or after January 1, 1996.

It should be noted, however, that no substantive rule changes have been made in this move to delay effective dates. In addition, for plan years leading up to the applicable effective date of the final regulations, plans must be operated in accord with a good faith interpretation of the final regulations.

In simple terms, this means that in situations where the good faith standard applies, a reasonable interpretation of the relevant statutory provisions of the final regulation will be deemed to be reasonable, good faith compliance.

Remedial Amendment Period Deadlines

The end of the remedial amendment period is critical, for it is the last day on which plan amendments may be adopted that reflect changes required by the final regulations, changes required in order for a plan to maintain its qualified status. (This is not to be confused with the extended effective date of the final regulation.)

The remedial amending period under Code section 401(b) has been extended to the last day of the 1994 plan year. For most plans maintained by tax-exempt organizations, and government plans, the deadline is the last day of the 1996 plan year.

Transitional Relief for Certain Plans

For individually designed plans, volume submitter, master or prototype plans, or regional prototypes, the transitional relief for benefit accruals provided under IRS Notice 91-38 (Alternative II-D) has also been extended.

TSA Transitional Rules Still Applicable

The transitional rules used for the testing of nondiscrimination under Code section 403(b)(12) were issued previously in Notice 89-23, and continue to apply to tax-sheltered annuity plans.

Is Proposed Pension Provision in Tax Bill Unconstitutional?

...States' Distribution "Source Tax" Rights at Issue

In the past two issues of *The Pension Digest* we have extensively discussed the tax bills under consideration in the House and Senate, which contain provisions expanding deductibility and further modifying the provisions of IRAs and other retirement plans.

States' Taxing Rights Affected

One item deserving further attention is the provision in H.R. 11 that a state would be barred from imposing a "source tax" on periodic pension distributions of out-of-state residents.

A hypothetical case illustrates this provision:

Gene Smith lives and works in New Jersey all his life. He accumulates $750,000 in qualified plan and IRA funds. Upon retirement he directly transfers these funds to a bank in Florida where he will now live.

According to the provision in H.R. 11, the Senate's current version of the tax bill, periodic distributions made in Florida could NOT be taxed by the state of New Jersey, where the funds were earned and sheltered from taxes all these years.

The effect of this would be permanent tax sheltering with respect to the state where the income was earned, and a windfall for the state of distribution. Given the patterns of retiree concentration in certain states, it is easy to envision some net gainers, and many net losers of tax revenue.

Avoidance of Double Taxation the Motive?

It may be that the motivation for this provision was to prevent potential double taxation of distributions, that is taxation by both the source state, and the state in which the distributions eventually occurred. This would of course be a desirable effect from the viewpoint of the retiree or plan participant.

Is This Equitable? Constitutional?

But the argument can certainly be made that the state which has provided services to an individual while he or she resided there, has some claim to tax for those services on income earned in that state. In addition, there are certain constitutional limits to the degree to which the federal government can allow or disallow taxation by states.

If passed, this provision of the tax law might become a matter for the courts. But it is our initial opinion that the federal government DOES NOT have the right to prohibit states from taxing income earned in that state, either when earned or upon distribution (or transfer) from a plan.

We have speculated privately on this issue before, and wondered when states would discover the tax dollars that might be escaping them in this way. The ultimate result of the attention given this subject in current legislation may be to rouse more "sleeping dogs" in state capitols, and make them aware of an issue that has been largely overlooked until now.

This is an issue we're sure to hear more about in the future. PD

Correction

In the last issue of *The Pension Digest* (August), our story entitled "New IRA Legislation Waiting in the Wings" contained both graph and text references to the trend in total IRA contribution levels between 1981 and 1990. The amounts referred to were listed in millions, whereas they should have been reported in billions.

The Pension Digest EXTRA included with the August newsletter discussed the new rollover, transfer and withholding rules with respect to qualified plans. Under Public Law 318 which takes effect January 1, qualified plan distributions that are not directly transferred to another qualifying retirement plan must have 20% withheld. We incorrectly reported that only distributions for those under 59-1/2 were affected. However, all are affected. PD

An Unusual Case of Retirement "Earnings"

...IRA Annuity, TSA Policy Credits Scrutinized as Potential PT

In a case determined via Letter Ruling (9230033) earlier this year, the IRS ruled that the issuance of policy credits to Individual Retirement Annuity and TSA holders in exchange for their membership interest in a mutual life insurance company did not constitute a prohibited transaction.

Had this issuance been deemed a prohibited transaction, the consequences would have been the loss of tax exempt status for the holders of these IRAs and TSAs. But were these policy credits in effect contributions - potentially excesses - or actual distributions, wherein the usual tax or penalty consequences would also apply?

Case Background

Insurance Company A is initially a mutual life company, with no common stock, but with each policyholder having a "membership interest" in the company. One of the rights held by members is the right to share in the distribution of the surplus of Company A if it should be liquidated.

In order to raise equity capital to enhance its competitive position and strengthen its capital base, and finding sources unavailable to it as a mutual company, Company A's Board of Directors decides to "demutualize," and to reorganize as a stock life insurance company.

In exchange for their interest in the mutual company, some members receive stock in the new company, some cash or policy credits. Those holding IRAs and TSAs are to receive policy credits, which are an increase in accumulation account value of their annuity.

The amount received (value of the membership interest) is based on the contributions to surplus made by each policyholder's plan or policy.

Were Policy Credits Paid for Membership Interest a Prohibited Transaction? Contributions? Distributions?

The IRS analysis is long and detailed. But among the IRS' comments:

"...As a general rule, all interest, dividend, capital growth, stock

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Retirement Earnings— *Continued from page 3*

distributions or any other change in the nature of assets, through reorganization, recapitalization or otherwise, are held as part of the tax-deferred solution, i.e. the TSA or IRA arrangement, until the assets are distributed. Only upon distribution are such increases in account value taxable to the recipient...

"Central to our analysis of your submitted ruling request is the question of whether or not membership interests in a mutual insurance company are within the TSA or IRA arrangement. In this regard, any membership interests in a mutual insurance company which arise from the purchase of an insurance contract are inextricably tied to the contract from the time of purchase..."

"...The conversion of membership interests...to policy credits, pursuant to the Plan, is a mere change in form of one element within the TSA or IRA arrangement to another...The policy credits are treated...in the same manner as any other return of, or return on, an investment within the TSA or IRA arrangement, and are not regarded as having been received by the...policyholder."

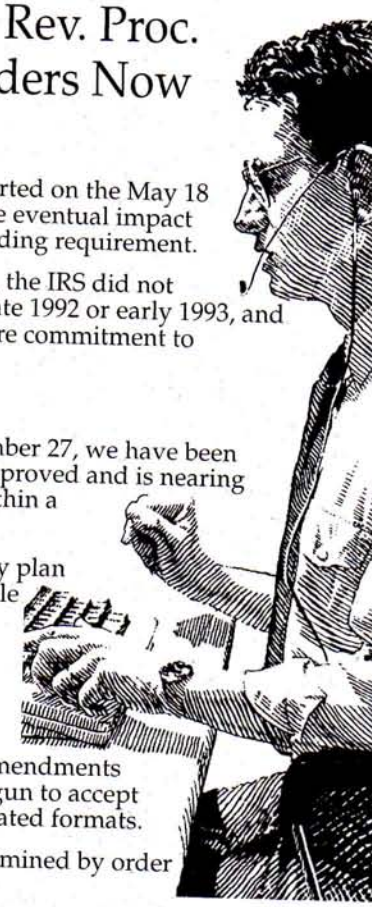
The IRS ultimately concluded that the receipt of policy credits:

1. was not a prohibited transaction, and therefore the affected TSAs and IRAs were not subject to loss of tax-exempt status.

2. was not a distribution, and therefore not taxable as current income. Nor would withholding apply.

3. need not be considered a contribution to the plan, and therefore could not be a potential excess contribution.

IRA Plan Amendments for Rev. Proc. 92-38 Available Soon — Orders Now Being Accepted



In the June issue of *The Pension Digest* we reported on the May 18 issuance of IRS Revenue Procedure 92-38, and the eventual impact this would have on all IRA plans due to its amending requirement.

We informed readers that, as of that June date, the IRS did not expect to issue revised IRA plan language until late 1992 or early 1993, and that they should not be pressured into a premature commitment to purchasing these amendments.

IRS Finalizes New IRA Plan Language

Now, in a conversation with the IRS on September 27, we have been informed that the new plan language has been approved and is nearing printing, and that official release will be made within a matter of weeks.

It is now generally understood that the primary plan changes will be to Article IV (Distributions), Article I to include the QP-to-IRA rollover/transfer changes, and possibly others of comparatively minor impact.

Given this information, we are informing customers that the first steps of the amending process can begin. With the availability of these amendments expected to be just weeks away, CWF has now begun to accept amendment orders, based on either of two anticipated formats.

Orders will be shipped on a priority basis determined by order date.

Comprehensive Six-Page Amendment

This would satisfy ALL amending requirements to date, in a six-page amendment format

Simplified Two-Page Amendment

For those accounts which have been kept up to date in terms of required past amendments, and/or were opened with up-to-date forms since 1988 or 1989, a simpler two-page amendment may serve your purposes (an assessment of this option will be made by us for you on request).

Please call our Customer Service Department with any questions you may have, at 1-800-346-3961.

IRAs May Not Hold S Corporation Stock, IRS Rules

A recent IRS ruling has determined that an IRA trust cannot be the holder of S corporation stock.

Certain trusts are permitted to hold S corporation stock, specifically those described in Code section 1361. The determination in this ruling turned on the taxation mechanism for IRAs versus section 1361-governed trusts.

The beneficiaries of section 1361 trusts are taxed on a CURRENT basis with respect to the trust's share of the income, deductions and credits of the S corporation. IRAs on the other hand (an IRA is a section 408(a) trust), are taxed upon distribution, as specified in Code section 72.

Because of this conflict between taxation time frames, IRAs do not meet the rules for those trusts that may hold S corporation stock.

S Corp Termination the Result of Improper Transfer?

Fortunately for S corporation shareholders, the IRS notes that in the event of an ACCIDENTAL transfer of S corporation stock to an IRA, the shareholder can request relief under Code section 1362(f) from the normal outcome of S corporation termination.

Withholding — *Continued from page 1*

discussed below. The requirement to amend qualified plans is found in Code section 401(a)(31).

This section requires that for a plan to be qualified it must authorize such direct transfers of any eligible rollover distribution. The plan will have to allow the distributee to (1) elect to have a distribution paid directly to an eligible retirement plan; and (2) specify the plan to which the funds are to be paid. In such case, the distribution must be in the form of a direct trustee to trustee transfer. This right to have funds transferred applies only to the extent that the eligible rollover distribution would have been included in gross income but for these special rules.

For these purposes, not all section 401(a) plans are eligible retirement plans. A section 401(a) plan is an eligible retirement plan only if it is a defined contribution plan, the terms of which permit the acceptance of such distributions. The prototypes of Collin W. Fritz and Associates are already written to permit the acceptance of qualifying rollovers and/or qualifying transfers between QP plans, but revised documents are being written to accommodate the mandatory transfers from the QP plan to an IRA.

Code section 402(e)(6) provides that any amount transferred in a direct trustee to trustee transfer in accordance with section 401(a)(31) shall not be included in income for the taxable year of the transfer.

The 402(f) Notice Requirement

Old Law. A plan administrator was required to furnish a written explanation to an employee explaining whether his or her distribution qualified for rollover or 5/10 year averaging treatment. Many plan administrators failed to furnish such a notice, either out of ignorance or outright disregard for the rule.

New Law. The notice requirements still exist and in fact have been expanded. A plan administrator shall, within a reasonable period of time before making a distribution which qualifies to be rolled over, provide a written explanation to the recipient (participant, beneficiary or alternate payee):

1. Of the provision in the plan document under which the recipient may have the distribution directly transferred to another eligible plan.

2. Of the provision in the plan document which requires the withholding of tax on the distribution if it is paid to the recipient (not directly transferred).

3. Of the provisions of the federal tax law under which the distribution will not be subject to tax if rolled over to another eligible plan within 60 days after the date on which the recipient received the distribution.

4. If applicable, an explanation of 5-year averaging, 10-year averaging, and capital gain treatment.

After being furnished this information the prospective recipient can decide whether to be paid these funds (and to have automatic withholding of 20%) or to transfer the payment to another eligible plan.

What Distributions Qualify or are Eligible to be Rolled Over?

Keep in mind that the plan administrator only needs to give the special notice to a person whose prospective distribution is eligible to be rolled over.

The new law rules are extremely liberal. Almost any amount distributed qualifies to be rolled over. Under the old law, only distributions which met the definitions of a qualified total distribution or a partial distribution qualified to be rolled over. Many distributions did not qualify and many taxpayers learned this the hard way, when the IRS informed them that their rollovers to IRAs were excess contributions.

The New Rule. The distribution to a participant of any portion of his or her account balance with respect to a qualified plan or a tax sheltered annuity will be eligible to be rolled over, except that two types of distributions do not qualify. A required minimum distribution does not. Nor does any distribution which is one of a series of substantially equal periodic payments made for a specified period of 10 years or more, or for the life of the employee or the joint lives of the participant and his or her beneficiary.

If the Distribution is One Which Qualifies to be Rolled Over, Then How Does a Participant Elect to Have the QP Distribution Paid Directly to an IRA?

The IRS is to furnish guidance on this topic. The approach is to combine the requirements of Code section 402(f) with the withholding notice/election rules.

The IRS is supposed to be drafting a form which the employer will furnish the employee for the instruction. We will inform you as soon as the IRS issues their suggested language. We have also drafted our own form, #859. It is available now.

What Plans Qualify as an Eligible Retirement Plan so that They May Receive a Transfer or Rollover Contribution From a QP Plan?

There are four such plans: (1) an IRA, (2) an IRA annuity, (3) a 401(a) plan and (4) a 403(a) annuity plan. Rollovers between 401(a) qualified plans to participant to 401(a) were permissible under the old rules, but only if the distribution was a qualified total distribution. A partial distribution was only eligible to be rolled over to an IRA. The new law will permit partial QP distributions to be rolled to another QP plan.

What Plans are Eligible to Receive a Transfer Contribution Which is to be Treated as a Rollover Under Section 408?

This is a "deemed" rollover since the funds are moving between plans which are not of the same type (QP and IRA). There are only two such eligible recipient plans: (1) an IRA, and (2) an IRA annuity.

Section 402(c)(5) indicates that such a transfer for purposes of this title shall be treated as a rollover contribution as described in section 408(d)(3). Most consultants are recommending custodians report this transfer contribution on the Form 5498 as a rollover contribution.

Is It Still Permissible to Transfer Funds From One Qualified Plan to Another Qualified Plan?

Yes. Transfers between qualified plans are still permissible if both plan documents authorize the transfers. But the law still does not require a QP plan to be written to accept a transfer from another QP plan.

Discussion of Additional Rules Which Govern Rollovers

The governing rules are now found in Code section 402(c). As will be seen, many of the old rules continue to apply. There no longer is a section 402(a)(5), (6) or (7). The effect of this change is that the references found in Article I of Form 5305-A (the basic IRA plan language) will have to be changed.

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If you are a member of CWF's consulting service and you have any questions regarding these new rules, please call one of our qualified consultants at 1-800-346-3961.

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Set forth below is a discussion of each subsection of 402(c):

1. Exclusion From Income. Any portion which is paid in the form of an eligible rollover distribution may be rolled over. But if the distribution includes property other than cash, then that property must be rolled over. This means the recipient cannot substitute other property which he or she owns.

2. Maximum amount which may be rolled over. The maximum amount is that amount which will be subject to tax (includible in income), but for the rollover. The old law stated that it was the fair market value of the assets at the time of distribution, less any voluntary nondeductible employee contributions. The new law states that the maximum amount rolled over or transferred shall not exceed the portion which is includible in gross income.

The approach may have differed, but after-tax employee contributions still do not qualify to be rolled over.

3. Transfer (sic "rollover") must be made within 60 days of receipt. A recipient is only allowed to exclude a distribution from his or her gross income if the rollover is made within 60 days following the day of receipt.

Note that there is no attempt to clarify whether there would be any type of extension for the fact that the 60th day ended on a Saturday, Sunday or holiday.

4. Eligible Rollover Distribution — referred to above.

5. Transfer Treated as a Rollover Contribution Under Section 408 — discussed above.

6. Sale of Distributed Property. The approach of the old law is continued.

A. Transfer of Proceeds From Sale of Distributed Property Treated As Transfer of Distributed Property.

Item 1 above required that the actual property distributed be rolled over. An exception is provided here. If the property is sold, the proceeds may be rolled over since the proceeds are treated as if they had been received in the distribution.

The IRS has indicated that there must be a bona fide sale. A recipient who receives 1000 shares of EDS at $98 cannot sell the shares to herself for $98,000 and put cash of $98,000 in a rollover IRA. She could sell the shares to an unrelated third party and then roll over the proceeds.

B. Proceeds Attributable To Increase In Value.

The subsection provides that any appreciation in the value of the asset from time of distribution to time of sale will also be treated as if it had been received in the distribution. Thus, any dollars due to appreciation in value also can be rolled over.

C. Designation Where Amount of Distribution Exceeds Rollover contribution.

This subsection is important. It covers the situation wherein the participant receives funds or assets not all of which are entitled to be rolled over, and some of the assets consist of property other than money. That is, there is a portion which is not includible in income and there are assets other than cash.

The rule then is: unless the taxpayer designates otherwise, the law will assume that there is a ratable split between that portion of the money and other property which is nontaxable and that portion which is taxable and thus eligible to be rolled over. The designation once made is irrevocable and must be made no later than the filing deadline for that year's tax return, plus extensions.

D. Nonrecognition of Gain or Loss.

If all of the proceeds are rolled over, then there is no gain or loss recognized on the sale of distributed property. This means there will be gain or loss recognized pro rata if all of the proceeds are not rolled over.

7. Special Rules for Frozen Deposits.

If a recipient of a distribution deposits those funds into a financial institution and those funds become a frozen deposit, then the counting of the days for the 60-day limit is tolled. A frozen deposit is one which may not be withdrawn because of the bankruptcy or insolvency of any financial institution, or any requirement imposed by the State in which such institution is located by reason of the financial failings of other institutions.

Another special rule provides that the 60-day rollover period cannot end earlier than 10 days after such amount ceases to be a frozen deposit. The effect of this rule is that the 60-day period may actually become a 69-day period. For example, if a deposit is frozen at day 59, the person will still have 10 days to make the rollover contribution.

8. Definitions. The terms qualified trust and eligible retirement plan are defined. These were defined above.

9. Rollover Where Spouse Receives Distribution After Death of Employee.

A payment to a surviving spouse is eligible to be rolled over to an IRA or IRA annuity (but not another qualified plan) unless it is a required minimum distribution or is one of a series of substantially equal periodic payments.

10. Denial of Averaging For Subsequent Distributions. If a distribution is ever excluded from income because of these rollover/transfer rules, then subsequent distributions are not eligible for special averaging treatment.

A rule found in Code section 402(e)(l)(B) also needs to be considered. Any amount paid to a spouse or former spouse pursuant to a qualified domestic relations order is eligible to be rolled over if the distribution would qualify under the above described rules, if the spouse were substituted for the employee.

What are the New Withholding Rules for Distributions From a QP or a 403(b) Annuity?

The rules depend on whether the distribution is periodic or nonperiodic.

Withholding and Rollover Rights for Periodic Distributions

Code section 3405(a) sets forth the rules for periodic payments. A periodic payment is defined as a series of payments over a period longer than one year.

Old Law. In general, these payments are treated as if they were wages. It is permissible for a participant to instruct that he or she does not want withholding. These distributions never qualified to be rolled over.

New Law. Basic rules are unchanged. That is, this section was amended only for cross-references. No substantive changes. These distributions continue to be ineligible for rollover treatment. Since periodic distributions are ineligible for rollover treatment, the employer will not need to furnish the section 402(f) notice and explanation.

Withholding and Rollover Rights for Nonperiodic Distributions

A nonperiodic distribution is any one which is not a periodic distribution. In most cases these are total payouts made

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to a participant because she or he has terminated service, retired, or the employer has terminated the plan. Or these are payments made to a beneficiary because the participant has died.

Old Law. The old rules for withholding on nonperiodic payments are set forth in Code section 3405(b), while those for defining what distributions from a qualified plan are eligible to be rolled over are found in Code section 402(a)(5).

Under the old law there were two types of nonperiodic distributions from QPs for withholding purposes - those which were qualified total distributions (QTD) and those which were not (non-QTD). The amount to be withheld for a QTD was determined by referring to a special tax table which had been developed with the assumption that the recipient of the QTD would be eligible to use 10-year averaging when determining the taxes owed. The non-QTDs were not eligible for 10-year averaging, so the amount to be withheld was 10% of the distribution amount.

The IRS played its word game and defined that any distribution which was payable from an IRA upon demand was a nonperiodic distribution subject to withholding at the 10% rate.

Under the old law an IRA distribution could never be a QTD, but it could have been either periodic or nonperiodic. The IRS played its word game and defined that any distribution which was payable from an IRA upon demand was a nonperiodic distribution subject to withholding at the 10% rate.

The withholding rules for distributions from IRAs have not changed.

New Law. The approach of the new law pertaining to withholding on QP distributions maintains the prior tradition of recognizing two types of distributions. But now, there are no longer the concepts of Qualified Total Distributions and non-Qualified Total Distributions, as there were before. Instead there is "Type 1" - those distributions eligible to be rolled over to another eligible plan - and "Type 2," those distributions which are not eligible.

If the distribution is one which qualifies to be rolled over then there must be withholding at the rate of 20% unless the participant elects to have the funds transferred to an eligible retirement plan. This new rule is found in Code section 3405(c). A recipient of such a distribution cannot waive the 20% withholding. It is mandatory.

Under the new rules almost every nonperiodic QP distribution is eligible to be rolled over. Thus, the 10% rule has little meaning for distributions from qualified plans.

The wage table approach will still be used for periodic QP distributions. A participant may still elect not to have such withholding.

The 10% rule will still govern for IRA purposes since subsection (c) does not apply to IRA distributions. The recipient of an IRA distribution still may elect not to have withholding at the 10% rate.

Change with Respect to Conduit IRAs

Code section 408(d)(3)(A)(ii) and (iii) provide the authority for conduit IRAs. That is, the funds are rolled from a qualified plan or a 403(b) annuity to an IRA and eventually back to a QP or 403(b) annuity. This section states when the funds may be rolled back to another qualified plan or a 403(b) annuity.

The old law required that the original distribution from the QP plan had to be a qualified total distribution. The new law has no such requirement. <u>Now, partial distributions from QP plans may be contributed to a conduit IRA account.</u>

If a Person Receives a Distribution and the Plan Administrator Withholds the Mandatory 20%, is This Person Still Eligible to Roll Over Some or All of the Distribution Amount to an IRA?

Yes. The following examples will illustrate this question/answer. Let's assume that Angela Cuomo is entitled to be paid $100,000 from her employer's profit sharing plan. The entire $100,000 is attributable to employer contributions plus related earnings. That is, she has not made any nondeductible employee contributions. The form of the payment to her is such that she is eligible to roll over the funds. She does not elect to "transfer" the $100,000 to one of the four qualifying plans. Thus, the plan administrator will withhold $20,000. She will be paid $80,000. The amount withheld is simply her prepayment of taxes which might be owing because of the distribution of the $100,000.

What is the maximum amount which she could roll over? She could roll over $100,000. However, since she only has $80,000 she would need to have cash of $20,000 available to her from other sources (savings, checking, etc.). If she rolled over the $100,000, she would be refunded the amount withheld ($20,000) if there are no other reasons why additional tax would be owing.

Could she roll over a lesser amount than the $100,000 — for example $80,000, or $55,000 or $25,000?

Yes. The tax rules stay the same. Whatever amount is not rolled over will be included in gross income and taxed at ordinary income tax rates.

Thus, if she would roll over $70,000, she then would pay tax on the $30,000. If she was in the 28% tax bracket, she would owe $8,400 in taxes on this $30,000. All other tax situations being equal, she then would be entitled to a refund of $11,600 ($20,000 - $8,400).

If she chose not to roll over any of the $100,000 and we assume that she is not eligible for 5/10 year averaging, then she would pay tax on the $100,000. If she was in the 28% tax bracket, she would owe taxes of $28,000 on this $100,000. She has had only $20,000 withheld, so she would owe an additional $8,000.

As we have discussed previously in *The Pension Digest*, the reason for this law change was to make it easier for the IRS to collect tax dollars from those who may fully intend to roll over their QP payment, but who for various reasons do not. PD

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Question. I was confused by the July article titled, "Violating the Once A year Rollover Rule." I thought a person was allowed one rollover for each separate IRA. Would you please offer an additional explanation on IRA rollovers?

✔Answer. For some time the IRS in Publication 590 has written that an IRA accountholder is allowed one rollover per separate IRA per 12 month period. In contrast, the governing statute states that you are only allowed one IRA rollover per year. The IRS has liberalized this rule somewhat, but not totally.

The IRS made a statement in the 1991 Publication 590 which it had not made in previous editions. What the IRS said in the 1991 590 publication was this: If an IRA accountholder withdraws funds from "IRA #1" and then rolls over these funds to "IRA #2," then he or she would have to allow the 12 months to expire before he or she could withdraw funds from IRA #1 or IRA #2 to be eligible to roll them over. Why? The funds in IRA #2 originated from IRA #1 and thus are subject to the 12-month rule. IRA #2 is not considered a separate IRA until the 12 months have expired. We believe this is reasonable since the funds originated from IRA #1.

You also state that you have told certain accountholders that they may within a 12 month period make a rollover from both an account they have with you, and one they have with another institution. We understand that the funds at institution #2 originated from the IRA at your bank.

Unfortunately, you have given these accountholders erroneous information. If the funds in an IRA at institution # 2 originated in your bank, they are not eligible for rollover until 12 months have elapsed. The accounts are different, but the funds in the two IRAs - for IRS purposes - are not.

This is the rule/situation which was violated in the case discussed in the July newsletter. The accountholder rolled funds from IRA #1 into IRA #2 at a different institution. Before the 12-month time period had expired he then took two distributions from IRA #2, which he tried to roll back over. The IRS and the court said he was not eligible for the rollover treatment. The fact that the funds were now at institution #2 did not make them a separate IRA for rollover purposes since they had originated from IRA #1 within the 12-month period.

Although the IRS has never clearly addressed the question in writing as to what they mean by a "separate IRA," we at CWF have always maintained that this refers to the IRA plan agreement and not the time deposits. We do not necessarily maintain this position because we know it is correct, it is simply the most conservative approach (i.e. no problems if this approach is adopted).

Data Processing Dilemma

You indicated that if an accountholder is paid funds from four separate CDs (either upon maturity or upon surrendering with interest penalties assessed), that your data processing system will prepare four Form 1099-R's for the accountholder.

You have wondered if this approach might not cause your customer some problems with the IRS, since they will see four distributions, of which only one will appear to be eligible to be rolled over. We agree that it certainly might. We would suggest that you take the steps necessary to generate just one Form 1099-R. Your approach of transferring the funds from three of the CDs into the fourth and then paying out of the fourth CD would work.

The once per 12-month period rule applies to distributions from IRAs and not qualified plans.

For an additional discussion of the IRA rollover rules, please review pages two and three of the April, 1992 newsletter.

Question. I have a number of IRA accountholders who are 70-1/2 or older who have named their spouse as their primary beneficiary and who have named their estate as the contingent beneficiary. They could have named their children, grandchildren, brothers, sisters, etc. as the contingent beneficiaries, but chose to name their estate (perhaps for simplicity reasons). Are there any reasons why it might not be a good idea to name the estate as the contingent beneficiary?

✔Answer. Yes. If the spouse beneficiary would die before the accountholder, the RMD calculation for the accountholder will be changed to require the use of a single life expectancy factor (speed up distributions) regardless of whether the accountholder had elected to use recalculation or the one-year reduction method. *Why?*

There are at least three rules which interrelate to produce this result.

One RMD rule is that a change in the beneficiary will not affect the required minimum distribution calculation unless the change would require a faster distribution of the funds. A second RMD rule is that the naming of a non-person as the beneficiary requires that a single life expectancy factor be used in the RMD calculation. A third RMD rule stipulates that when there is a change to a faster distribution schedule that the new schedule goes into effect for the following year.

In situations where living persons are the contingent beneficiaries and not an estate or revocable trust, the RMD calculation using the one-year reduction method will not be modified unless the new beneficiary would be older than the deceased beneficiary. That is, the one year reduction method will continue to be used unchanged even if the beneficiary has died. The use of the recalculation method would require the change to a single life expectancy factor.

Such is not the case if the beneficiary switches from the spouse to the estate as happens in this situation. A change in beneficiary can occur either voluntarily or involuntarily. The change which has occurred here is an involuntary change.

The rule is that the estate will now be treated as if it had been the designated beneficiary as of the required beginning date, except the new schedule is not applied retroactively; it only applies for the calendar years occurring after the year in which the beneficiary has changed.

For those of you who have IRA accountholders who have named their estates as their contingent beneficiaries, you may wish to give them the chance to name other living persons as the contingent beneficiaries.

Note that there will be the same result if there is no contingent beneficiary named and the sole primary beneficiary (with no named contingent beneficiary) dies before the accountholder. Most IRA plan agreements state that the accountholder's estate is the named beneficiary if there is no named beneficiary.

We hope this answer illustrates the complexity of the RMD rules. The RMD rules are only one factor which an accountholder should consider when designating beneficiaries.

Question. I have an IRA accountholder who wishes to have her self-directed IRA buy series EE bonds. Can the bank as the IRA custodian buy the series EE bonds?

✔Answer. No. There are no tax or IRA rules which would prevent the purchase of series EE bonds. However, the Federal Reserve has an internal administrative policy that they do not sell these bonds to IRA accounts. We are aware of such sales being permitted if the Federal Reserve is wrongly furnished the individual's name as the buyer and not the IRA account.

Question. I have an IRA accountholder who now owns series EE bonds and because they are paying an interest rate greater than many bank time deposits would like to put the series EE bonds in the IRA (and the IRA would pay the accountholder cash equal to the fair market value). Can this be done?

✔Answer. No. Such a sale of series EE bonds or of any other asset by the accountholder would be a prohibited transaction. PD

The Pension Digest invites your questions and comments.
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