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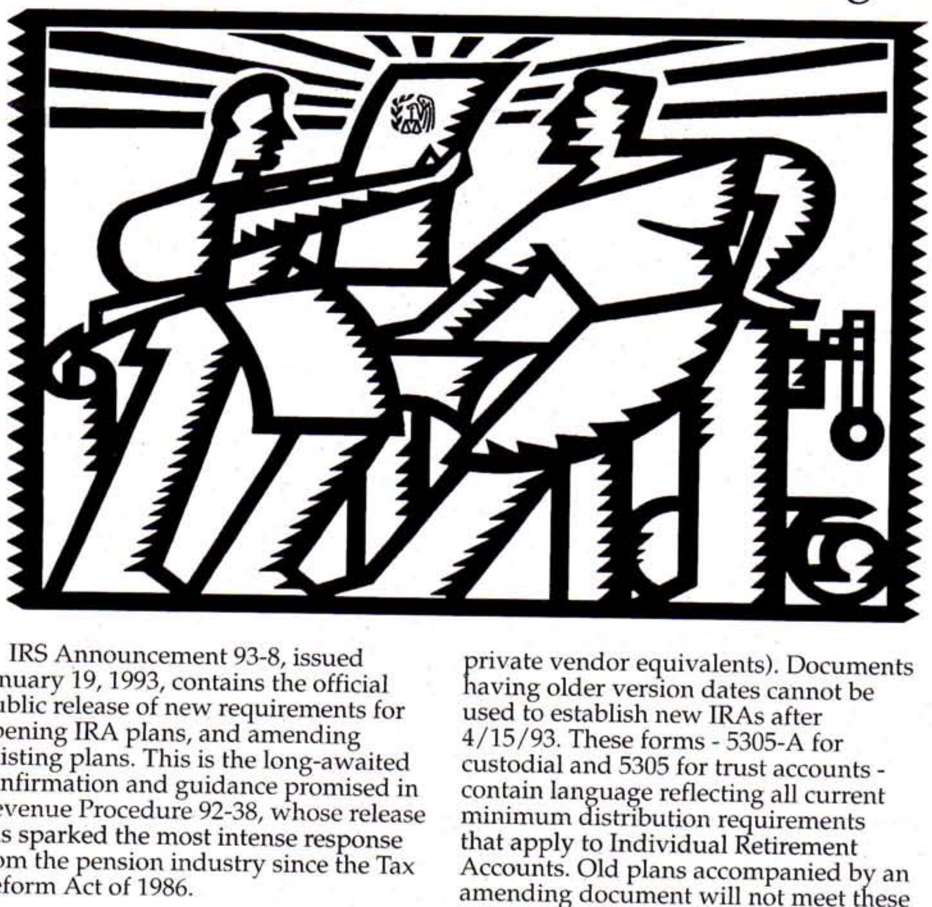
Announcement 93-8: IRS Officially Issues New Rules for Opening IRAs, And Revising Existing Plans



Also In This Issue —

IRS Announcement 93-8, issued January 19, 1993, contains the official public release of new requirements for opening IRA plans, and amending existing plans. This is the long-awaited confirmation and guidance promised in Revenue Procedure 92-38, whose release has sparked the most intense response from the pension industry since the Tax Reform Act of 1986.

Significant changes to IRA plan language - primarily those relating to minimum distributions - have been anticipated for some time. Some of these changes have already been in actual use in keeping with provisions of the "proposed regulation," though they were not a part of the current IRA plan document language.

Here is a summary of the major provisions of Announcement 93-8, which addresses these changes.

Opening New IRAs

IRAs opened after April 15, 1993, must use IRS Forms 5305 or 5305-A with revision dates of October, 1992 (or private vendor equivalents). Documents having older version dates cannot be used to establish new IRAs after 4/15/93. These forms - 5305-A for custodial and 5305 for trust accounts - contain language reflecting all current minimum distribution requirements that apply to Individual Retirement Accounts. Old plans accompanied by an amending document will not meet these rules.

Amending Existing Plans

Sponsors (custodian/trustees) of IRA plans previously established using PRE-October, 1992 forms must "adopt amendments that meet the requirements of Code section 408(a)(6) on or before December 31, 1993...," according to Announcement 93-8.

Announcement 93-8 further describes that amending may be completed by:

1. EXECUTING a Revised Form by the plan sponsor and the accountholder

2. FORWARDING to the accountholder the Revised Form

3. Forwarding substitute language contained in Article IV of the Revised Form, replacing the same portions of the Old Form

4. Forwarding a "Model Explanation" to the accountholder

The "Model Explanation" Alternative

The fourth option described above is to furnish the accountholder with "a written explanation of such requirements..." The IRS has provided a "model explanation" that can be used for this purpose.

Major Provisions of the Model Explanation

These provisions include:

* a description of what constitutes the accountholder's "70-1/2 year"

* the rule that each year's distribution must meet or exceed the minimum distribution amount for that year

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* the calculation method and timing for minimum distributions, with reference to additional rules and exceptions contained in IRS Publication 590

* a caveat that "This explanation only summarizes the minimum distribution rules..." and that other rules and explanations not discussed may apply, some of which might prevent the accountholder from using certain options described in the model explanation. And further, that the accountholder is advised to consult with their personal tax advisor or Publication 590 for more detailed information.

Merits of Using Full Amendment vs. Substitute Language or Model Explanation Options

The substitute language and model explanation approaches are deviations from past IRS practice in cases where changes to the IRA plan are major. Neither of these alternatives is comprehensive in its approach to covering the technical changes. Furthermore, the issue should perhaps also be considered from customer relations or customer service perspectives. "What will be most informative and least confusing to the customer?" is a question that deserves to be asked when an amending decision is made.

Both the model explanation and substitute language options have weaknesses.

* They do not discuss the rollover/transfer rules, which are a part of the disclosure portion of an IRA document. The rules relating to rollover/transfer options are of major concern to IRA accountholders, so much so that they comprise a substantial portion of the IRS Publication 590. No guidance in understanding these provisions is given the accountholder in the model explanation. They are instead expected to familiarize themselves by reading Pub. 590 or (hopefully) consulting with their tax or legal advisor.

* Unlike a comprehensive amendment, the article replacement approach or model explanation are not able to correct for any plan document deficiencies that might be pre-existing, such as failure to execute a prior required amendment.

* Using either of these approaches, there will eventually be inconsistency of IRA plan document Articles from one customer to another. This is because Article V of the prior IRS forms 5305 and 5305-A has been eliminated and the remaining Articles renumbered, leaving the document with seven basic Articles, rather than eight. All new plans opened, and the accompanying documentation, will have this reduced number of Articles.

Therefore, future references to specific plan Articles (as in potential future amending) may not be consistent across the entire custodian institution's customer base.

Good-faith Effort to Promote Customer Understanding of IRA Provisions Has Always Been an IRS Mandate

In general, an IRA accountholder is supposed to be able to read the disclosure portion of their IRA plan document (and its amendments, if applicable) and be able to understand all the provisions of their IRA plan.

Even if this were not an IRS requirement, which it is, there would still be a customer relations aspect to be considered. Many customers believe that their custodian/trustee bears some responsibility to assist them in understanding the IRA plan, or at least in making it as non-complex as possible.

The model explanation and substitute language approaches fall short of providing this understanding, in our opinion.

Therefore we clearly favor the providing of a genuine amendment, per IRS amending options #1 and #2 described above.

Misconceptions About 20% Distribution Withholding Continue

Few changes in retirement plan administrative procedure have generated the amount of confusion that the new mandatory 20% withholding rules for qualified plan and tax sheltered annuity distributions have created.

As we indicated in a response in our Check-it-Out column in the December Pension Digest, this confusion has been one of the most frequent issues faced by our pension consultants. The uncertainty about IRAs and 20% withholding continues to confound personnel in financial institutions large and small, with no particular pattern. So much so that we are prompted to briefly summarize and repeat here a description of those plans to which the 20% withholding does - and does not - apply, per UCA '92.

20% Withholding Not Applicable to IRA Distributions

Distributions FROM IRAs are NOT AFFECTED by the mandatory 20% withholding rule. IRA distribution withholding (for federal taxes) is taken at the rate of 10% for on-demand IRA deposits (most IRAs), and at the rate set by the prevailing wage tables for those deposits that are not considered on-demand. But an accountholder can elect NOT to have withholding taken from any IRA distribution. (In such cases, however, the estimated tax payment requirements apply, and those whose distributions have been under-withheld from may face a penalty at tax time.)

20% Withholding Applies to Most QP, TSA Distributions

Participants in qualified plans or tax sheltered annuity plans do not have this option to "elect out" of withholding. Most qualified plan or tax-sheltered annuity distributions that would qualify to be rolled over to an IRA or to another plan must have 20% withheld from that distribution. And with the new rules of UCA '92, virtually all QP or TSA distributions, whether total or partial, so qualify. Therefore these distributions are covered by the new 20% withholding rule. NOT included are transfers made via a newly defined transaction known as a "direct rollover," in which a true distribution to the participant does not occur, and the funds are at no time made-out-to, or negotiable by, the participant.

Three Common Exceptions

There are, however, three common types of true distributions from a QP or TSA that ARE NOT required to have 20% withheld. These exceptions include any Required Minimum Distribution, annuity payments, or any payment that is one of a series of periodic payments made for a period of ten (10) years or more. Less common exceptions include non-deductible employee contributions, and distributions qualifying for the death benefit exclusion.

In summary we repeat - REPEAT - that distributions from IRAs are NEVER SUBJECT TO THE 20% WITHHOLDING RULE.

IN THE FACE OF CHANGE, KEOGHS STILL OFFER SPECIAL ADVANTAGES

As popular as IRAs and Simplified Employee Pensions may be due to their simplicity and easily met qualification rules, there remains a very real place for the qualified plan...the Keogh plan in particular. Keoghs for the self-employed, including sole proprietors and partners, offer some contribution options, distribution flexibilities, and beneficiary options that IRAs or SEPs do not. Furthermore, they offer tax advantages to the business entity itself. Thus the same individual may receive a double benefit as both employer and employee.

But admittedly, the attractiveness of the Keogh plan has been somewhat tarnished in recent years, by such things as the loss of 10-year-averaging tax treatment for many Keogh participants, as well as the phase-out of the option of capital gains tax treatment.

Changes in Five & Ten Year Averaging of LSDs

Prior to the Tax Reform Act of 1986, a Keogh participant could receive a lump sum distribution prior to age 59-1/2 and average it over either five or 10 years for income tax purposes. TRA '86 restricted averaging LSDs to ages after 59-1/2, made it a one-time option, and eliminated 10 year averaging as an option except for those individuals 50 years old or older by 1/1/86, who were thereby "grandfathered in." This age class of individuals can also use the favorable "capital gains" tax treatment on any qualifying lump sum distribution (taxed at 20%). For younger individuals, capital gains tax treatment was thereafter to be subjected to a phaseout schedule.

More Changes With UCA '92

The talk-of-the-town in the pension plan industry in 1992 was the Unemployment Compensation Amendment of '92's provision for automatic withholding of 20% from qualified plan or tax-sheltered annuity distributions. This is to apply to distributions that would qualify for rollover to another plan (QP, TSA or IRA), with 20% withheld unless such distributions are directly rolled over to a new plan. The rules for rollover eligibility were broadened considerably, making most LSDs not only eligible for rollover, but simultaneously subject to this 20% withholding. The net effect is expected to be an increase in rollovers, and a decrease in the number of individuals taking lump sum distributions.

This dramatic move was made to ensure payment of taxes on such distributions, based on IRS experience with plan participants taking large distributions, then being unable to pay the appropriate taxes when these funds were treated as income in the year of distribution.

Critics, however, contend that a major motivator for the 20% withholding rule was the intent to raise tax revenues to ease the passage of an extension of jobless benefits included in UCA '92.

Three Common Exceptions

Three common exceptions to the rule requiring 20% withholding on distributions are Required Minimum Distribution (RMD) payments at age 70-1/2 and older, annuity payments and periodic payment distributions made over a period of 10 years or longer.

Keoghs, Congressional Intent, and the Failed Tax Bill of '92

The tax bill presented to President Bush in December of 1992 was HR 11, which was eventually vetoed. But had it passed, HR 11 held provisions further restricting Keogh plans (see accompanying chart for a comparison of existing and certain proposed rules). No one is making firm predictions of when, or with what provisions, a new tax bill will reach the desk of President Clinton. But based on the character of Keogh provisions contained in HR 11, there is great concern about maintaining some of the fundamental provisions of Keogh plans.

The new administration's Treasury Secretary, Lloyd Bentsen, has long been an advocate of liberalizing IRA plan provisions in favor of the plan participant. But his position on other retirement plans is not so well known. And, given the fact that it was a Democratically controlled Congress that passed HR 11 with its potential new restrictions on Keoghs, it remains anyone's guess just what new legislation will bring. Keoghs may not fare as well as IRAs.

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PRESENT LAW & 1992 TAX BILL PROVISIONS COMPARED

Following is a comparison of some key current provisions of Keogh plans, and changes that would have been made by the 1992 Tax Bill, had it been signed into law by President Bush. It remains to be seen which, if any, of these provisions will be proposed in any new tax legislation brought to the desk of President Clinton in 1993.

	CURRENT LAW	PROPOSED CHANGE
FORWARD AVERAGING of Lump Sum Distribution	**One-time option of five-year forward averaging of LSD on or after age 59-1/2 (using tax rate in effect in year of distribution**	**Five-year averaging would NO LONGER BE ALLOWED.**
"TRANSITION RULES" - the "grandfather clause"	**Rules in TRA '86 allow those age 50 by 1/1/86 (or trust or estate thereof) to use five or ten-year averaging of LSD, BEFORE or AFTER age 59-1/2**	**New bill would have retained the "Transition Rules", as described at left.**
CAPITAL GAINS	**An individual (or their trust or estate) receiving an LSD covered by the Transition Rules can elect to retain the capital gains character of the pre-1974 portion of the distribution, using the tax rate of 20%.**	**The new bill would also have retained the provisions pertaining to capital gains, as described at left.**

Keoghs—*Continued from page 3*

Some Anticipated Keogh Developments

- Loss of Five-Year Averaging

This was a provision of HR 11, with the exception that the "transition rules" apply, grandfathering-in those who had reached age 50 by 1/1/86 for five year averaging.

- Loss of Capital Gains Tax Treatment

This would only continue to be available to those grandfathered-in as described above.

- Ten-Year Averaging?

Some fear that there is even the potential for loss of the 10-year averaging provision that was previously grandfathered in with TRA '86, though this is speculation.

- Elimination of the "Death Benefit Exclusion"?

This provision exempts $5,000 of a plan participant's distribution (due to death) from current year taxation for the receiving beneficiary. This is a provision considered "at risk" in the next round of legislative pension proposals.

Continual Change is Unfair to Participants, Businesses

When one reviews the changes that have been made to, or proposed for, Keoghs over the years, it's easy to draw the conclusion that a potential plan participant is gambling on the future actions of Congress. Given the necessity for long-term thinking when one considers retirement planning, it would seem hard to maintain a real sense of security in the face of such repeated change. This is counter-productive to the goal of stimulating retirement savings.

Continued Advantages of Keoghs

Despite legislative tampering's potential for weakening the Keogh plan's position among retirement options, these plans retain some special benefits.

* In addition to the $5,000 death benefit exclusion already described, these benefits also include:

* A beneficiary may qualify for the option of 10-year averaging of a lump sum distribution.

* Creditors are much less likely to reach Keogh funds than those in an IRA, or a non-ERISA-governed savings arrangement.The U.S. courts have recently affirmed the "sanctity" of qualified plans from seizure in creditor claims situations, whereas IRAs have been successfully penetrated in a number of states.

JOT IT DOWN

Distribution Date — Not Transaction Date — Determines Rollover Certification Administrative Form Use

As most pension professionals are aware, The Unemployment Compensation Amendment '92 legislation not only mandated 20% withholding from many qualified plan (QP) and tax sheltered annuity (TSA) distributions, but brought with it the need for revised administrative forms and procedures.

One of these changes is the process of rollover certification. Certification is typically a two-fold process, consisting of the QP or TSA holder's instructions to their plan administrator, and - with respect to the new custodian/trustee at a financial institution - the irrevocable election to make the rollover transaction, as well as certification that the funds being rolled over qualify for such treatment.

New forms that have resulted from UCA '92 distinguish between QP/TSA rollovers to an IRA, and IRA-to-IRA rollovers (CWF's #65 form). They also provide for the new transaction called a "direct rollover" (CWF's #66).

Use Caution in Forms Use ... Date of Distribution Controls

The new rules of UCA '92 took effect January 1, 1993. Does this mean that as of this date only new administrative forms may be used?

The answer is no. The controlling factor determining whether old-rules forms or new-rules forms will be used is THE DATE OF DISTRIBUTION from the QP or TSA. If the distribution took place on or before December 31, 1992, old-rules forms are to be used. If the transaction took place on or after 1/1/93, then new-rules forms must be used.

"Old-Rules" Forms Remain Available

If your institution has found itself without an adequate number of such old-rules forms, we will continue to provide them during this transition period on a postage-only basis to those customer institutions using CWF rollover certification forms.

IRA Custodians Reminded of Need for New Plan Forms as of 4/15/93

Elsewhere in this issue is a lengthy discussion of the release of IRA Announcement 93-8, which describes amending options and deadlines for compliance with Revenue Procedure 92-38.

We noted that one of the compliance requirements is the use of new IRA plan documents to open IRAs after April 15, 1993. After this date, custodians must use IRS 5305 or 5305-A documents dated October, 1992, or a private supplier equivalent (such as CWF's 50-P, 51-P or 52-P) having this or a later date. USING AN OLD DOCUMENT COUPLED WITH A NEW AMENDMENT IS NOT SATISFACTORY.

You should review your inventory well before this time, and make sure you have new IRA plan documents on hand for IRAs opened after this date.