THE Pension Digest

Published Since 1984 Collin W. Fritz & Associates, Inc., *"The Pension Specialists"* February, 1993

Also In This Issue —

- Data Processing Aspects of Inherited IRA Accounts
- Unwelcome Pension Provisions Retained in New House Legislative Proposals
- CWF's Conference Classic
- Prohibited Transactions Must Remain a Priority Concern
- New IRS Form 575 Gives Updated Rules for Reporting Pension Income on 1992 Tax Returns
- ✓ Check It Out

New Withholding Rules May Generate Rollover Deposits From TSAs

Financial institutions have come to expect most rollover deposits to come from traditional corporate or small business-based qualified plan sources. No doubt these deposits will be even more common due to the new withholding/ rollover rules as defined by the Unemployment Compensation Amendments of 1992. However, thanks to the liberalization of rollover rules with respect to Tax Sheltered Annuities (TSAs), there may be more business coming their way from these accounts, too.

TSAs are governed by Code section 403(b), and have traditionally been associated with the insurance industry, rather than financial institutions. (Securities firms, however, have gotten into the 403(b) game, and some now offer a range of investing options qualifying for 403(b) status.)

Under current federal income tax law, time deposits and savings accounts are not permissible investments for section 403(b) purposes. For a number of reasons it appears that the banking industry has not felt it worthwhile to do the political work needed to become authorized for this segment of the pension business.

TSAs are very commonly used by those in the teaching profession, and some in the medical profession as well. For professionals such as these, the TSA has become an income deferral vehicle similar to the 401(k)s in which many corporate employees participate, or Keogh plans for self-employed individuals.

Many Distributions Will Now Become Rollovers Instead

When the new rules of UCA '92 were announced, it became apparent that many pension "distributions" might become rollover transactions instead. This will be the result of plan participants' efforts to avoid the punitive effects of the 20% withholding requirement on a distribution from a qualified plan or TSA that qualifies for rollover treatment. And, with UCA 92's very liberalized rules on qualifying rollovers, most distributions will qualify and therefore be subject to this 20% withholding.

A Brief History of TSA-to-IRA Rollover Rules

The rules that have governed the handling of TSA rollovers have fluctuated considerably over the years.

Pre-1984

Prior to the Tax Reform Act of 1984 it was very difficult to roll over funds from a 403(b) annuity to an IRA since there normally had to be a lump sum distribution.

Post-1984

The Tax Reform Act of 1984 allowed for almost any partial distribution (50% or more) to be rolled over. Thus, the movement of funds from TSAs to IRAs was relatively simple, but many in the banking industry were not aware of this.

Post-1986

The Tax Reform Act of 1986 added the requirement that the distribution had to be on account of death, disability

Continued on page 3

Published by Collin W. Fritz and Associates, Ltd. Subscription Rate: $65 per year.

Data Processing Aspects of Inherited IRA Accounts

With the inevitable mortality of more and more IRA accountholders, the purpose of this article is to summarize an IRA custodian's postmortem reporting responsibilities and point out various errors that must be avoided. To demonstrate reporting duties, two hypothetical situations are set forth. In one the spouse is the beneficiary. In the other there are two non-spouse beneficiaries.

Hypothetical Situation #1. David Chlian died on 11-3-92 at the age of 74. His sole beneficiary was his spouse Christie Chlian. Christie was 67. She did not elect to treat his IRA as her own until 1-28-93. However, in 1992 she did receive the amount of $876.89 which was his required minimum distribution amount for calendar year 1992. No distributions were made to him in 1992 prior to his death. In 1993 the amount of $3,500 was paid to Christie Chlian after she had elected to treat the IRA as her own.

What Form 1099-Rs Must You as IRA Custodian Prepare?

The absolute cardinal rule is that the IRA custodian must prepare a Form 1099-R when funds are paid to anyone, and not prepare the form if a distribution has not taken place. The form is prepared in the name, address and social security number of the person who actually is paid the funds.

The IRA custodian must generate a 1992 Form 1099-R to Christie Chlian because she was paid $876.89 in 1992. The principal boxes would be completed:

Box 1 (Gross Amount)	$ 876.89
Box 2 (Taxable Amount)	$ 876.89
Box 4 (Withholding)	0 (assumed)
Box 7	A reason code of 4 (Death)

A Common Spouse 1099-R Mistake

What common mistakes are made in generating or not generating Form 1099-R's with respect to spouses after an IRA accountholder has died?

Even though the 1992 payment was made to Christie Chlian, the Form 1099-R might incorrectly be made out in the name of David Chlian.

This is a fairly common error since the computer account has always been in David Chlian's name. This is one of the reasons it is so important to set up the inherited account as, "Christie Chlian as beneficiary of David Chlian."

If you had wrongly issued a Form 1099-R to David Chlian rather than Christie Chlian, you would need to do two things to correct the error.

With respect to the Form 1099-R prepared using David Chlian's name, address and social security number, you would need to prepare a corrected Form 1099-R and complete boxes 1 and 2 with zeros to indicate that no distribution was actually made.

With respect to Christie, you would need to complete for the first time a Form 1099-R to show the amount she was paid.

Two Possible Data Processing Approaches

When in 1993 Christie elects to treat David's IRA as her own, one of the following two data processing approaches should be used.

1. The first approach is to treat the movement of funds from David's IRA to Christie's IRA as a non-reportable transfer. Under this approach a Form 1099-R is not to be generated. The reason? The funds were never "paid" or distributed to her. (Collin W. Fritz and Associates, Ltd. prefers this approach because the funds are never actually paid to the surviving spouse, and there is no potential for tax liability.)

2. The second approach would be for the IRA custodian to prepare a 1993 Form 1099-R with a reason code "4" to Christie, and also report the addition of these funds to her account as a rollover contribution on the Form 5498. IRS Publication 590 does appear to set forth the approach that the surviving spouse can choose to make the IRA his or her own by rolling it over as though the surviving spouse had established it.

Since Christie was paid $3,000 in 1993, the custodian will need to generate a 1993 Form 1099-R as follows:

Box 1 (Gross Amount)	$3,000
Box 2 (Taxable Amount)	$3,000
Box 4 (Withholding)	0 (assumed)
Box 7	A reason code of 7 (Regular)

The reason code is a 7 because this IRA is now hers, and she is over age 59-1/2.

Hypothetical Situation #2. IRA accountholder Eleanor Whittier died on 8-13-92. She was 68 at the time of her death. Prior to her death she had been paid $6,200. The fair market value of her IRA on the date of her death was $28,766.42. She had designated two beneficiaries - a daughter, Susan Whittier-Eisel age 45 and a son, John Whittier, age 42. Each was to receive 50%. John needed funds so he withdrew his entire portion of $14,383.21. He completed a beneficiary election form and a distribution form. He elected to waive withholding. Susan had not yet decided what she wanted to do. She left her portion in the bank, and on December 31, 1992, its fair market value was $14,486.88. The bank set up an inherited IRA account for Susan. This account was titled, "Susan Whittier-Eisel as the beneficiary of Eleanor Whittier." By 12-31-92 she had not furnished her instructions as to how she intended to comply with the death distribution rules.

What 1992 Form 1099-R's must the IRA custodian prepare?

Again, the absolute cardinal rule is that the IRA custodian must prepare a Form 1099-R when funds are paid to someone, and at no other time. The form is prepared in the name, address and social security number of <u>the person who is actually paid the funds</u>.

The IRA custodian must generate a 1992 Form 1099-R to Eleanor Whittier because she had been paid $6,200 prior to her death. The principal boxes would be completed:

Box 1 (Gross Amount)	$6,200
Box 2 (Taxable Amount)	$6,200
Box 4 (Withholding)	0 (assumed)
Box 7	A reason code of 7 (Regular)

Her personal representative would use this information to prepare the final tax return for Eleanor.

The IRA custodian must also generate a 1992 Form 1099-R to John Whittier (using his address and social security number) because he was paid $14,486.88 in 1992. The applicable boxes would be completed:

Box 1 (Gross Amount)	$14,383.21
Box 2 (Taxable Amount)	$I4,383.21
Box 4 (Withholding)	0
Box 7	A reason code of 4 (Death)

Code 4 should always be used when funds are paid from an inherited account to a beneficiary. (If this were a case of a surviving spouse who elects to treat the deceased spouse's IRA as his or her own, that IRA would no longer be an inherited IRA for reason code purposes. That is, once a spouse elects to treat the account as his or her own, then the use of code 4 is inappropriate and one of the other codes (1,2,3,5,7) must be used.)

A Common Non-Spouse 1099-R Mistake

1. When the inherited account is established for (in this example) Susan, many times IRA personnel will select the "death" transaction code to handle the decrease in the account balance of the decedent, and use some type of contribution code for the movement of the funds to the inherited IRA. The consequence of doing so is that the

Continued on page 3

Data Processing—*Continued from page 2*

computer system will incorrectly generate a Form 1099-R. Since the funds vere not paid to Susan, it is wrong to prepare and issue a Form 1099-R to her.

Rather than using a death code for this situation, a transfer code needs to be used since this transaction should not be reported to the IRS. IRA software should, but most currently does not, contain such a "transfer to or from an inherited IRA" transaction code. IRA software should be modified to include such transaction codes/descriptions.

If you have made this type of error, you will need to prepare a corrected Form 1099-R and complete boxes 1 and 2 with zeros to indicate that no distribution was actually made.

2. Even though the beneficiary funds were paid to John Whittier (the son beneficiary), in many such cases the Form 1099-R for an after-death distribution is still generated in the name, address, and social security number of the deceased IRA accountholder (Eleanor).

If you have wrongly issued a Form 1099-R to the decedent rather than the beneficiary, you will need to do two things to correct the error. For Eleanor, you will need to prepare a corrected Form 1099-R and complete boxes 1 and 2 with zeros to indicate that no distribution was actually made, or correct the form to show the proper amounts if both the pre-death and after-death distributions were aggregated on one Form 1099-R.

For John as stated previously, you will for the first time need to complete a Form 1099-R to show the amount he was paid.

Liability Reminder: currently the rules of Code sections 6721 and 6722 do not apply to the preparation of Form 1099-R. The rules of Code section 6652(e) and 6047 govern. They provide for a penalty of $25.00 per day (with an annual maximum of $15,000) for the failure to prepare a Form 1099-R.

Note how harsh the penalty is if you fail to prepare a required Form 1099-R. This penalty is much harsher than the penalty of section 6721/6722 which is $50.00 per account.

Unwelcome Pension Provisions Retained in New House Legislative Proposals

In the January Pension Digest we described aspects of HR 11, the 1992 tax bill vetoed by President Bush, that appeared threatening to the tax-advantaged status of qualified plans. We further asked the rhetorical question whether they would resurface in 1993 legislation that might find its way to the desk of President Clinton.

Already at this early date in the new year, legislation with some of these provisions has been introduced by House Ways and Means Committee Chairman Dan Rostenkowski (D-IL). These pieces of legislation include the Tax Simplification Bill of 1993 (HR 13) and the Technical Corrections Bill of 1993 (HR-17).

In both bills are provisions to:

* eliminate five-year averaging of a lump sum distribution, which can currently be used as a means to spread out or reduce the immediate tax impact of such a pension distribution.

* repeal the death benefit exclusion, whereby a beneficiary of a plan participant may shelter $5,000 of a death distribution from federal taxation.

SAR-SEPs, QPs Affected

* SAR-SEPs (SEP plans with a salary-reduction arrangement) would be allowed an increased number of participants.

* The current 50% participation requirement for a SAR-SEP would be eliminated.

* Contribution limits to plans covering the self-employed would be altered.

* Additional provisions deal with non-discrimination rules for qualified cash or deferred arrangements and matching contributions.

* Rules on highly compensated employees would also be altered.

Rollovers/TSA's—*Continued from page 1*

or separation from service. The effect of this change was to make it much harder to move funds from a TSA to an IRA. The TSA holder's need to separate from service was a requirement that could not be met by most active teachers.

Current Rules

UCA 1992 has again made it much easier to move money from a TSA to an IRA. As discussed in recent newsletter articles, there is no longer the requirement that there must be a lump sum distribution or a separation from service. Almost all distributions on or after 1-1-93 are eligible to be rolled over. In general, the main distributions which are not eligible are: (1) a required minimum distribution; and (2) a payment which is part of a schedule of payments which is to last for 10 years or more.

Will Perceived "Safety" Prompt More TSA-to-IRA Rollovers?

Although there have been a relatively small number of insurance company failures that have resulted in default on annuity payments and other obligations, there is some feeling in the marketplace that a fully insured investment, such as that available with an IRA account at a financial institution, may be a safer place to keep retirement dollars. But there may be a trade-off, however, given the current slump in interest rates paid on insured CD investments in many parts of the country. Earnings in a financial institution-based IRA may be lower, depending on the investment vehicles available.

Will Competition for These Dollars Develop?

IRA custodians and insurance companies must realize that there may be more competition for the 403(b) deposits than there has been in the past. Financial institutions which cannot accept original deposits into 403(b) annuities may now seek these funds as IRA rollovers.

Prohibited Transactions Must Remain a Priority Concern

With recent IRA changes occupying the attention of financial institution pension specialists, it's understandably difficult to maintain adequate concentration on all the necessary IRA administration basics. With the need for new IRA plan documents, amending requirements, restrictions on rollovers from other plans to IRAs, and expectations of what may lie ahead on the legislative horizon for IRAs, it's easy to forget about some of the more static but nonetheless important aspects of IRA administration.

Of these areas of ongoing IRA concern, one of the least forgiving of shortcomings and failures is the area of prohibited transactions. The concept of the "prohibited transaction" stems from Code section 4975 and ERISA objectives to protect an IRA account from the possibility of loss through bad judgement, or intentional mismanagement.

Some of the other possible IRA administration infractions - excess contributions for example - can be made right with a minor fine and/or other corrective action. But once committed, prohibited transactions are "final", and have the effect of removing the tax-sheltered status from an IRA account. Specifically, when a prohibited transaction occurs the account balance is deemed to be distributed as of the first day of that year, and must be reported as earned income in that year. A very harsh result! Penalties may also be levied.

Clearly, this is a very good reason to avoid committing (or participating in as custodian/trustee) a prohibited transaction.

Some Common Prohibited Transactions

Among the most frequently encountered prohibited transactions are:

* Pledging of IRA assets as collateral for a loan. IRAs clearly should not be "encumbered" or pledged in this manner.

* Buying from - or selling to - one's own IRA account, as in the case of an accountholder purchasing shares of stock that his or her IRA account holds. This is true even if the fair market value is paid. The stock could be sold on the open market and the proceeds rolled back into an IRA. But a direct sale to the accountholder is prohibited.

* Leasing or renting an IRA's real estate assets to a relative, or a business controlled by the accountholder or relative. Here there is clearly the potential to "short change" the IRA account, thus the prohibited status of such a transaction.

* A financial institution acting as IRA trustee selling bank-owned investments to the IRA.

* Bank directors or officers directing assets (in a self-directed account) into bank or parent holding company stock. This is prohibited because such a transaction could leave the officer with loyalties divided between the bank entity and the IRA plan. No situation in which there would be an incentive or opportunity for the plan to be taken advantage of negatively with respect to its earnings, is to be allowed.

This does not mean that bank customers, or even employees of a bank, cannot purchase that bank's (or its parent company's) stock as a self-directed investment. So long as these individuals are not in a position to act on the bank's behalf to influence policies or decisions that might run counter to the IRA account's best interest, there is no prohibited transaction.

Enforcement, and Prohibited Transaction Determination

While the authority for this category of infraction rests with the Code and ERISA, and the IRS itself is charged with the responsibility to impose any potential excise taxes for prohibited transactions, the Department of Labor (DOL) is responsible for enforcement. The DOL actually has the authority to grant exemptions for transactions which might otherwise be considered "prohibited", under certain circumstances.

Furthermore, the DOL has a procedure whereby it will review a situation and issue a letter determining whether a transaction is prohibited. This is a lengthy process, however, and it is simpler and generally wiser to avoid potential prohibited transaction territory whenever possible.

(For further reference on prohibited transactions we direct you to past issues of *The Pension Digest*, specifically the November 1990 and December 1989 issues. Or you may wish to review the discussion of prohibited transactions in Chapter 3 of Collin W. Fritz & Associates' IRA Procedures Manual.) PD

✓✓Check It Out

Question: In 1992 our customers, Manuel and Christina Silva, had compensations of $65,488 and $565 respectively. They are both age 53. What are the possibilities for their IRA contributions.

✓ Answer.

1. They each may have their own contribution based on their respective incomes. Manuel would be eligible for a $2,000 contribution. Christina would be eligible for a $565 contribution.

2. Another alternative is that they also may have "spousal IRAs" for 1992. In this case they could split the maximum joint contribution of $2,250 any way they wanted as long as no more than $2,000 was contributed for any one person. In order to qualify for the spousal situation, Christina would need to instruct the IRA custodian that she elected to be treated as not having any compensation.

Although their maximum contributions decreases $315 (from $2,565 to $2,250), they may feel it more important to have the contributions split more equally between their two accounts (or their cash flow may not permit them to make the full contribution of $2,565). When one spouse elects to be treated as not having any compensation, this gives the couple the ability to allocate more funds to one spouse's IRA than otherwise would be the case. 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.

New IRS Form 575 Gives Updated Rules for Reporting Pension Income on 1992 Tax Returns

Taxpayers (and those assisting taxpayers) having pension or annuity income that must be reported on their 1992 income tax returns have been advised that the IRS' newest Publication 575 offers updated guidance.

The taxation of lump-sum distributions is discussed, with special emphasis on the 20% withholding rule on distributions eligible for rollover, brought about by the Unemployment Compensation Amendments of 1992.

Calculating the taxation of annuities using the "simplified general rule" is also covered by this updated document. PD