THE
Pension
Digest

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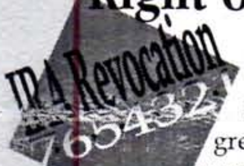
Summary of Data Processing Requirements Upon IRA Seven-Day Right of Revocation



In the April *Pension Digest* we discussed in great detail the withdrawal of current year contributions, including the newly expanded definition of that term. This month we will discuss the consequences of an IRA revocation, which has certain similarities. We will give particular emphasis to the data processing aspects of such transactions. (Please contact us if you wish additional copies of the April *Pension Digest*.)

The Internal Revenue Code's regulation 1.408-6(d)(4)(ii) stipulates that a person who has established a new IRA plan (not a new contribution to an existing plan) has the right to revoke or "disestablish" the IRA, within seven days of the date it was established. In such cases the entire initial contribution amount must be refunded.

Data Processing and the Revocation Process

The original contribution is reported on a Form 5498. A regular or spousal IRA contribution will be reported in Box 1, a rollover contribution (even if it is an excess contribution) in Box 2. Note that SEP or transfer contributions are not reported.

According to the IRS instructions:

1. If the contribution was a regular contribution, then completion of the 1099-R depends on whether any related income was returned to the revoking accountholder. In most cases, no income returned.

a. If no income was returned, then enter the gross amount in Box 1, $0.00 in Box 2a, and 8 in Box 7.

b. If income was returned, then enter the gross amount in Box 1, the income in box 2a. Box 7 is then completed with a code 1 if the accountholder is under age 59-1/2 or an 8 if 59-1/2 or older.

Note that the IRS instructions do no address a situation in which a contribution is made in one year and the revocation distribution is taken in the next. It would be our recommendation in such situations that you use a multiple code "1 P" in cases where the accountholder is less than 59-1/2 years of age, and a code "P" if over 59-1/2.

This opens a much broader subject of multiple code use, which we will expand upon in the July issue of *The Pension Digest*.

2. If the contribution is a rollover, a transfer or a SEP contribution, the IRA custodian must complete Boxes 1 and 2a with the gross amount.) The IRA custodian is to complete Box 7 with the applicable code of — once again — a 1 if the accountholder is under age 59-1/2, an 8 if the accountholder is 59-1/2 or over.

There is an additional rule that has the effect of making the IRA "revocation proof" as of the date of the initial deposit. That is the rule that allows an IRA custodian to furnish an IRA disclosure statement seven days in advance of the first deposit. The plan should also contain language specifying that the seven-day right of revocation only applies when the plan agreement and the disclosure statement are furnished at the same time. PD

Notice 93-26 Describes New Participant Waiver of 30-Day Consent Period for QP Distributions

Because the distribution of assets from 401(a) qualified retirement plans can have substantial tax consequences for a plan participant, pension law has been written to provide a certain degree of guidance and protection against distributions that might not be in a participant's best interest. This at times even includes protection against potential errors in their own judgment.

Two related regulations have been pertinent to this objective. Under section 411(a)(11)(c) of the income tax regulations, a plan participant's consent to a distribution — as for example in the case of termination of employment — is not valid unless the participant receives notice of their rights under the plan, INCLUDING THEIR RIGHT TO DEFER A DISTRIBUTION BY WITHHOLDING CONSENT, at least 30 days but not more than 90 days before such a distribution.

Continued on page 2

Also In This Issue —

Notice 93-26—*Continued from page 1*

Section 402(f), the second pertinent regulation, requires that a written explanation of the plan participant's rollover options, and other special tax rules, be given. The same 90 day/30 day notification period applies.

The Unemployment Compensation Amendment of 1992 (UCA 92) introduced greater QP (and 403(b)) rollover options, and provided for 20% withholding for those funds distributed rather than rolled over to another plan. This altered the written notification requirement to include explanation of the new direct rollover option, the much greater rollover flexibility now available for fund movements, and the potential tax consequences to the accountholder.

Rules "Protected" Participant

More than just protecting the right to be informed, 411(a)(11)(c) has in the past also served the function of discouraging the "consumption" of retirement savings by those of pre-retirement age. Under the pre-Notice 93-26 rules, even a participant's own election to receive a distribution DID NOT BECOME VALID until the end of 30 days from the time of notice.

(Note that this consent rule and 30-day waiting period did not apply to situations wherein the participant was of "normal retirement age," or was receiving a cash-out of vested benefits of less than $3,500, or was receiving a distribution from a government plan.)

But Notice 93-26, issued May 3, 1993, now allows ANY QP participant to waive their right to 30-days notice before a distribution, and to receive this distribution, or execute a rollover transaction, before such a 30-day period has elapsed.

Notice 93-26's relaxation of prior requirements has taken place following a request for comment made by the Internal Revenue Service and the Treasury, which sought opinions on the appropriateness of the 90/30 day period required by sections 411(a)(11) and section 402(f).

Most who commented believed that some relaxation of the rules was warranted. On one end of the spectrum, some felt that an annual notice to all plan participants should be considered adequate, rather than the necessity of notification on an individual plan participant basis. On the more conservative end of the spectrum, others felt that the 30-day "no distribution" period should be retained except in cases where a participant elected to make a direct rollover.

Following evaluation of the comments received, the IRS and Treasury determined that the 90-day component of the notification process should be maintained — allowing notice no more than 90 days before distribution — but the 30-day component relaxed. This, they concluded, would ensure timely notice of options and tax consequences, but would relieve the parties of the bur-

Continued on page 3

FDIC Notice Update: What are "Affected Accounts?"

The FDIC requirement to notify customers of reductions in maximum insurance coverage for certain retirement plan accounts has caused great concern and confusion among many financial institutions. Briefly, the new rules limit insurance coverage of IRA and certain other self-directed plan accounts to a maximum of $100,000 coverage in AGGREGATE, not $100,000 per account.

One of the most common and critical points of confusion is that of which customers must receive this Notice, which is to be sent by October 10, 1993 (or – in certain cases, by an instrument's first date of maturity after October 10, 1993).

After initially recommending that all accountholders receive this Notice, the FDIC — following a public comment period — modified its position to require the Notice be sent only to " ... those customers who have deposit accounts that could potentially be affected by the rule changes ... "

Interpretations Are Many, All But One Are Wrong

Various interpretations of what this means have surfaced, and become evident in the great number of consulting calls taken on this subject. Some financial institutions interpret this to mean that they must only send the Notice to depositors who have more than one of the potentially affected accounts, such as an IRA and a self-directed Keogh plan. Others have interpreted the rules to mean only those customers with multiple plans whose aggregate balance exceeds $100,000, and who will therefore be immediately impacted by a loss of coverage when the new rule takes effect December 19, 1993.

These interpretations, and others like them, are wrong. Quoting from the FDIC's supplementary instructions for the final regulation, " ... the institution must notify all customers WHO HAVE THE TYPES OF ACCOUNTS (emphasis ours) affected by the rule changes, not just those who have retirement or other accounts that individually, or in the aggregate, exceed the $100,000 limit ... "

All customers who have either an IRA, self-directed Keogh plan accounts, "457" plan accounts, OR accounts where an insured institution is acting in a fiduciary capacity, must receive the Notice. For most institutions, the greatest number of customers affected will be those with an RIA or Keogh account, ALL OF WHICH must receive the Notice, regardless of their account balances.

For further information, consulting customers may call our HOTLINE at 1-800-346-3961. PD

Notice 93-26—*Continued from page 2*

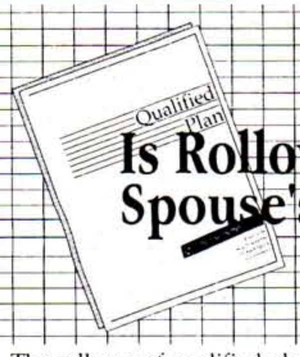
den of an enforced waiting period of 30 days before a QP distribution could take place.

Retention of the 30-day waiting period as a means to discourage pre-retirement withdrawals was deemed by IRS and Treasury to be unnecessary. They noted that the expanded opportunities for rollovers, and the generally well articulated and understood negative consequences of pre-retirement withdrawals made the mandatory 30-day waiting period unnecessary, IF THE PLAN PARTICIPANT CHOOSES TO WAIVE IT.

It is, however, still a plan administrator's responsibility to observe the 90/30 day guidelines. The plan participant must still be given the OPPORTUNITY to consider — for at least 30 days — the decision of whether or not to elect a direct rollover. It is only at THEIR option that the 30-day waiting period may be waived, if they have had an opportunity to make an informed decision, and so choose.

How About 403(b) Annuities?

Briefly, the rule with regard to section 403(b) annuities is not affected by these changes. Payors must still provide notice of (direct) rollover options within a "reasonable time period" prior to making a distribution, but need not comply with the 90/30 day 401(a) QP distribution rule. The 90/30-day guidelines are considered appropriate, however, and a 403(b) payor will be considered to have met the test of "reasonable time period" if they comply with these rules, with the modifications set forth by Notice 93-26. PD



Is Rollover of QP Distribution to Spouse's IRA a Valid Rollover??

The rollover of qualified plan distributions is a current "hot topic" in the pension industry. One reason is that UCA 92 has altered certain past practices and assumptions, leaving a significant amount of uncertainty as to what distributions are — and are not — qualified for rollover.

But since long before UCA 92, there have been thorny questions about what constitutes an allowable rollover from a qualified plan to another plan. Letter Ruling 9315031, issued January 21, 1993, is a case in point and stems from a situation pre-dating UCA 92. It addresses and answers — for this set of case facts at least — the question of whether a qualified plan participant may roll over funds distributed from a QP to an IRA belonging to his or her spouse.

In the case ruled upon, a participant received on March 21, 1992 a qualified total distribution (as defined in section 402(a)(5)(E)(i)(II) of the Internal Revenue Code) from a qualified profit sharing plan. This distribution was split up and deposited into three separate IRAs, \$60,000 and \$100,000 into two IRAs of his own, and \$100,000 into an IRA maintained in the name of his spouse.

Apart from any other consideration, the success of a rollover attempt hinges on whether the receiving account or plan conforms with the requirements of an "eligible retirement plan" as defined under Code section 402(a)(5)(E)(iv). Only if it does so, can funds deposited there maintain their tax sheltered status, and not be required to be included in one's gross income.

To this end, the QP accountholder asked the IRS to rule that:

1. His spouse's IRA be deemed to be an "eligible retirement plan," and

2. The amount rolled over to her account from his distribution be considered a valid rollover, and not be required to be included in his gross income.

While certain of the required conditions were met, and the rollover transaction took place within the required 60 days, one key requirement was — in the eyes of the IRS — NOT met. That provision requires that the IRA receiving the rollover be "... for the exclusive benefit of an individual or his beneficiaries ..." (after death).

The spouse's IRA that received the distribution was created for the benefit of that spouse, not for the benefit of the plan participant who rolled over part of his qualified total distribution into it. Thus her IRA was not a "qualified retirement plan" for purposes of receiving funds belonging to him.

This answer to question #1 also answers question #2: the amount rolled over was not deemed to be a valid rollover, and must be included in his gross income.

A Better Course of Action

We know of no reason why this QP plan participant could not have simply opened another IRA account to receive the \$100,000 that he deposited in his spouse's IRA. Had he done so, he would have saved himself the painful tax consequence of having to include that \$100,000 in income for the year in question.

A guiding principle that must be considered when moving or managing one's retirement plan assets, is that in general one cannot transfer one's plan assets to another person prior to one's own death. Were it possible to do so, one could imagine all manner of scenarios in which an individual in a highly taxed income tax bracket would transfer assets to an individual in a lower tax bracket, for the purpose of reducing the tax burden on those assets, or modifying the normal distribution structure.

Whose responsibility is it to inform such plan participants of the consequences of their action?

The IRS says it is the responsibility of the accountholder to observe the IRS Rules & Regs. But legally, the financial institution could be held liable. A completed rollover certification clarifying responsibilities would be helpful for the institution. PD

Contribution of Unencumbered Property to Plan Trust Judged a Prohibited Transaction

In the current economic climate, many businesses find themselves challenged to meet financial obligations. One of these obligations, not surprisingly, is the funding of pension plans.

One such company, faced with a need to satisfy its defined benefit pension plan funding obligations, chose to contribute several pieces of real property to meet these obligations.

More specifically "the firm" contributed several unencumbered properties to the trust fund that supported its tax-qualified defined benefit plans, then credited the properties' fair market value against its minimum funding obligation under ERISA.

This raised once again the long-unanswered question of whether property — rather than cash — may be contributed to a pension plan.

This action on the part of the firm was initially determined to be a prohibited transaction, and the firm found to be responsible for the payment of "substantial excise taxes." But this case followed a long and tortuous course, ultimately involving the Commissioner of Internal Revenue, the U.S. Tax Court, the 5th Circuit Court of Appeals, and the U.S. Supreme Court. Final resolution of this case came on May 24,1993.

How was it resolved?

The first action was taken by the Commissioner, who ruled this contribution of property to be a prohibited transaction under 26 U.S.C. section 4975(c)(1)(A), which forbids "any direct or indirect ... sale or exchange ... of ... property between a plan and a disqualified person such as the employer of those covered by such a plan." The commissioner interpreted the transfer of this property for the purpose of satisfying the firms' pension funding obligations as such a prohibited sale or exchange.

The Commissioner further made the point that in the handling of its income taxes, the firm treated the disposal of the properties it contributed to the pension plan as the sale or exchange of a capital asset. Further evidence, he deemed, that the definition of "sale or exchange" had been met for purposes of employing the prohibited transaction statute.

But the Tax Court did not support the Commissioner's position. It took the position that a reading of section 4975(f)(3) limits the application of 4975(c)(1)(a) to the end that only transfers of "encumbered" property are prohibited.

The Court of Appeals supported the position of the Tax Court, and also read 4975(f)(3) as "implying that unless it is encumbered by a mortgage or lien, a transfer of property is not to be treated as if it were a sale or exchange." The Court further contended that the treatment of a transfer of property as a "sale or exchange" for income tax purposes is irrelevant from a pension perspective, "because section 4975 was not enacted to measure economic income."

But a majority of the U.S. Supreme Court disagreed. The Court took the position that past judicial history has indeed established that the transfer of property to satisfy a monetary obligation is not only a well-established income tax rule, but has been determined to apply as well to pensions under 4975(c)(1)(A). It is, the Court contended, at least an indirect sale, and a form of exchange, with the law clearly forbidding "any direct or indirect ... sale or exchange ... of property between a plan and a disqualified person ... "

The Court expressed its position that it was Congress' intent to expand rather than limit the scope of the prohibited transaction provision. It interpreted this by Congress' action extending the "sale or transfer" interpretation to include the transfer to a plan of encumbered property that was NOT required to satisfy a funding requirement. Essentially, the court took this to mean that ANY transfer of property to a plan constituted a "sale or exchange," and thus was a prohibited transaction if it included a disqualified person.

The Court explained its interpretation in favor of further prohibitions on the transfer of property to a pension plan trust:

Quoting from the majority opinion, " ... this construction of the statute's broad language is necessary to accomplish Congress' goal. Before ERISA's enactment" ... there was ... "an open door for abuses such as the sponsor's sale of property to the plan at an inflated price or the sponsor's satisfaction of a funding obligation by contribution of property that was overvalued or nonliquid. Congress' response to these abuses included ... the addition of section 4975 to the Internal Revenue Code."

The Court noted that while the properties at issue in this case were not encumbered, and were not overvalued when transferred to the plan, there were costs — sales commissions — to the eventual selling of these properties, and one property was not sold for three and one-half years after being listed for sale by the pension trust. Clear evidence, in its opinion, of the kinds of complications involved when property rather than cash is paid to a plan.

The Court further stated that in general terms, "... as long as a pension fund is giving up an account receivable in exchange for property, the fund runs the risk of giving up more than it is getting in return if the property is either less valuable or more burdensome than a cash contribution would have been."

Thus, the firm in question was guilty of participating in a prohibited transaction, and liable for the appropriate excise taxes. Under Code section 4975, an excise tax equal to 5% of the amount involved in the prohibited transaction is assessed for each year, for each prohibited transaction. Section 4975(b) also states that when the transaction is not corrected within the taxable period, a further tax — a "second tier" tax — is imposed, which is 100% of the amount involved.

To give some sense of how expensive a prohibited transaction can be, this particular firm faced first-tier (5%) excise taxes of $749,000 for fiscal year 1985, and $482,000 per year for '83 and '85 to '88 inclusive. Second tier (100%) excise tax liability was $9,655,000. Total first and second tier excise tax liability was approximately $12.8 million.

A <u>very</u> expensive mistake.