THE Pension Digest

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Can Default 'Election' for IRA $70^{1/2}$ Distributions be Modified?

The model IRA plans written by the IRS (5305/trust and 5305-A/custodial) have default provisions in the event that an IRA accountholder does not make the necessary life expectancy calculation elections by the time they reach their post-age-$70^{1/2}$ Required Beginning Date.

When elected in a timely fashion, the accountholder may exercise their option to have their life expectancy calculated using either the non-recalculation (reduction-by-one) method, or the recalculation method (new calculation each year). But when no election is made by the accountholder by the time they reach their RDB date, the default provisions as now written by the IRS in Article IV of the IRA plan agreement come into play, and provide that the recalculation method will be used.

In situations of joint life expectancy initially based on accountholder and beneficiary lives, recalculation (following a death) may significantly accelerate the distribution, and thus taxation of plan assets.

Many IRA custodian/trustees have asked whether they may add provisions in plan agreement Article VIII that would change or override this default to what they deem to be the more favorable nonrecalculation method. Some have even asked if they can – also by Article VIII –

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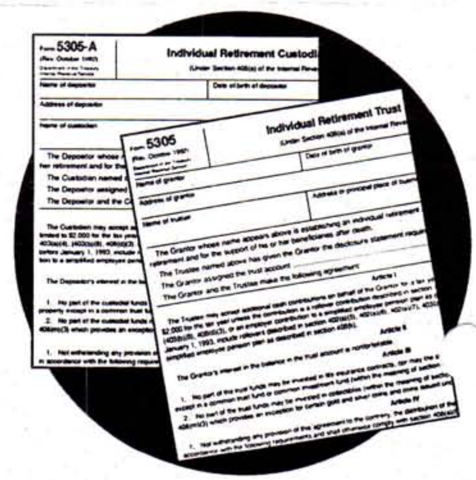

Important dates

IRA Fair Market Value Deadline is January 31

We would like to remind *Pension Digest* subscribers of the fast-approaching deadline for reporting of Dec. 31, 1993, IRA fair market values (FMV), which must be provided to accountholders by Jan. 31, 1994. This report is also known as the "customer statement".

1099-R Reminder, Too

IRA Custodian institutions are also reminded of the deadline of January 31 for Form 1099-R reporting to customers. The 1099-R reports both partial and total IRA distributions. It has a January 31 deadline because it may be needed by the customer for income tax reporting.

Consulting customers may call 1-800-346-3961 any time for clarification of questions about customer statement mailings.

Year-End Reporting Update:

How to Value Non-Market IRA Assets for Reporting

Custodians and trustees of Individual Retirement Accounts have certain reporting responsibilities which are dictated by the IRS. One of those duties is to report the fair market value of the IRA account as of December 31 of each year. This fair market value is reported to the accountholder and to the IRS on Form 5498.

If the IRA contains assets that are not readily marketable it is sometimes difficult to determine the fair market value (FMV) of that asset as of December 31. But does this excuse the custodian/trustee of the responsibility for accurate valuation and reporting?

The IRS recently responded to a number of pertinent questions on non-marketable asset reporting and valuation, as follows:

1. "Is an IRA required to value its assets on an annual basis?"

The IRS answer was expectedly in the affirmative: "... based on the fact that the Internal Revenue Service (the "Service") requires that the fair market value of the assets as of December 31 be reported on Form 5498, an IRA is required to value its assets on an annual basis."

2. Is an IRA required to value "hard-to-value" assets (e.g. partnerships, closely-held stock, collectibles, etc.) as well as exchange-traded securities?

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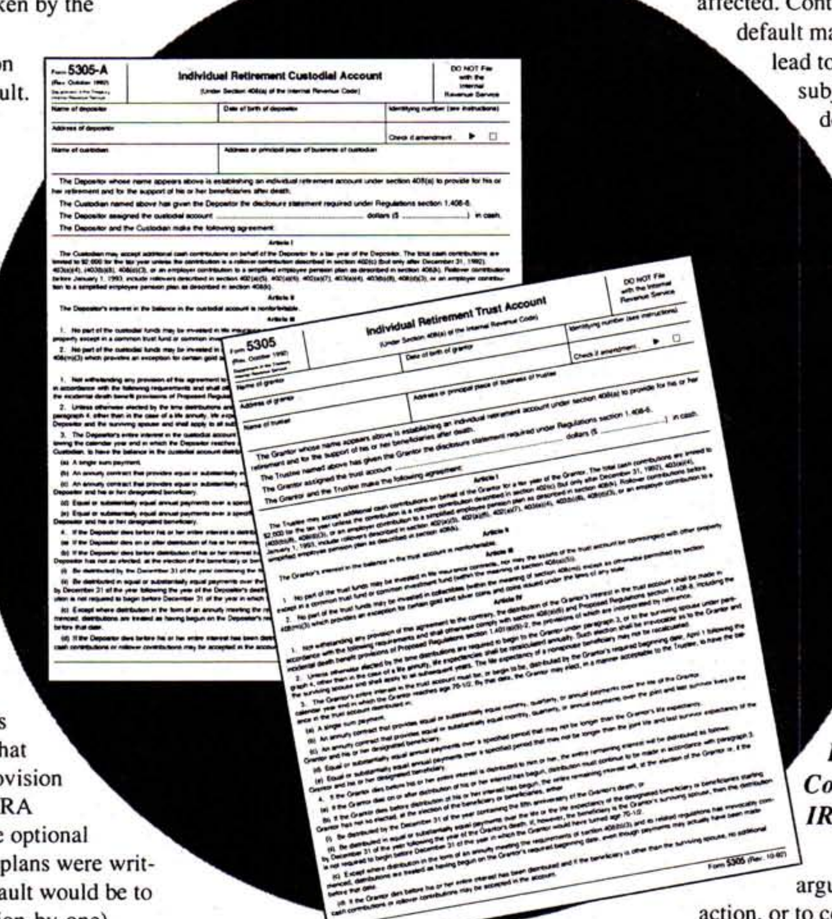
offer only the nonrecalculation option.

While some pension consultants have in the past altered the IRS' $70^{1/2}$ default election in the forms they provided, there is now more reason than ever to avoid such action.

Plan Language Changed in October 1992

Prior to the new October 1992 plan language, Article IV stated that if no election was made and no distributions taken by the Required Beginning Date (RBD), lump-sum distribution of the entire plan was the result. Article IV also stated that if non-recalculation was not specifically chosen, then recalculation would be the default. Presumably, this latter clause was for situations in which distributions had been taken by the RBD, but no election had been made. Before the new '92 plan's release, there was no IRS model plan language specifically forbidding the alteration of this default.



How Some Have Circumvented These Provisions

During this 1987-92 period, some pension consultants wrote IRA plan documents that replaced the IRS' default provision with one more favorable to IRA accountholders. By using the optional Article VIII language, these plans were written so that the automatic default would be to the nonrecalculation (reduction-by-one) method of determining life expectancy for $70^{1/2}$ accountholders.

Collin W. Fritz and Associates never adopted the approach of changing the IRS default language, because its compliance or legality had not, to our knowledge, been tested and confirmed. We knew that the IRS had adopted its recalculation-favoring default for a reason, and we were reluctant to attempt an unauthorized approach to modifying it.

IRS Refines Default, Adds New Limiting Provisions

In our opinion, the IRS has intentionally attempted to end default revisions via Article VIII by adding stronger limiting terminology to its October 1992 model-plan language. Thankfully, it eliminated any specter of a lump-sum distribution default, while retaining the aforementioned default-to-recalculation method provision.

New language that was not present in the 1987 document was added. Besides the Article IV language stating that $70^{1/2}$ accountholders who fail to make timely elections will default to the recalculation method, the IRS added the language: "Notwithstanding any other provision of this agreement to the contrary, the distribution of the Depositor's interest in the custodial account shall be made in accordance with ... (these) ... requirements."

By so doing, the IRS has in essence said that an IRA custodian can no longer "undo" the IRS mandated recalculation default if it uses the IRS 5305 or 5305-A model forms, including a vendor's version based on these model forms. The custodian/trustee may be able to make such a change if it adopts an IRA prototype that is expressly written to allow this provision. But such an institution will surely want to file for a favorable opinion letter with the IRS to see if this is allowable. But under the IRS model forms, it is not.

What Are the Potential Consequences if an Institution Has Used a Vendor's Model Form (Post-October '92 Version) Altered to Provide a Default to Nonrecalculation?

We believe that such an altered document would be without "force of law", or effectiveness. Any IRA plans dependent on such an altered default to provide a nonrecalculation election for an accountholder would not have accomplished this objective. In other words, any accountholder who did not specifically elect nonrecalculation would have actually defaulted to recalculation.

What Steps to Correct This Default?

The method used to recalculate annual required minimum distributions must be changed for any accountholders who are so affected. Continuing to use the unauthorized default may eventually (if not already) lead to an under-distribution, which is subject to a 50% excise tax on this deficiency. Since this is clearly a custodian error, it is not unlikely that an IRA accountholder would look to the custodian to pay some or all of the excise tax.

We also believe that the customer's plan should be corrected to reflect the proper default election language, which would require an amendment to the incorrect Article VIII provisions. Otherwise the potential for customer confusion remains.

Is There Room for an Argument or Interpretation of IRS Intent, Enough to Justify Continued Use of Altered IRS Model Forms?

We do not feel that a convincing argument can be made for such an action, or to contest the IRS position, based on even a liberal interpretation of the language of the new model forms. Thus, we would advise against use of such forms. We certainly would not administer $70^{1/2}$ required minimum distributions on the assumption that a case can or will be made for a nonrecalculation default.

Has the IRS Issued an Opinion Warning Against a Nonrecalculation-Default Alteration to the Model Plans?

We have seen no such published opinion. We have been asked if we have been given assurance that this is the IRS position. Our position is based both on the new, clearly written plan with its "Notwithstanding any other provision ..." language, and on VERBAL CONFIRMATION FROM THE IRS that Article IV cannot be changed by adding contrary provisions in Article VIII. PD

Reporting update

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"Similarly, the requirement that fair market value be determined annually for purposes of Form 5498 necessitates the valuation of all IRA assets, including 'hard-to-value' assets."

3. Are non-traded asset value standards the same for IRAs as for defined benefit (DB) plans and defined contribution (DC) plans?

In a condensed response: "... the general approach, methods and factors of Revenue Ruling 59-60 are ... applicable to valuations of corporate stock for income and other tax purposes ... and ... also apply to valuations of corporate stock in IRAs."

(Revenue Ruling 59-60 is commonly used to value non-publicly traded assets for estate and gift tax purposes.)

4. Who is responsible for ensuring that an IRA's assets are properly valued?

"... The person responsible ... is the IRA trustee or issuer, because under the Service's reporting requirements, that person is responsible for reporting the correct fair market value of the assets."

5. Can a fiduciary (the custodian/trustee) evade responsibilities by having the client sign a release, indemnification or other instrument?

"... The IRA trustee or issuer cannot evade valuation responsibility by having the participant sign a release, indemnification or other instrument, because the trustee's or issuer's responsibility for valuation derives from the Service's reporting requirements, which cannot be waived by participant action."

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Applying Revenue Ruling 59-60 When Valuing Such Assets

What are "... the general approach, methods and factors of Revenue Ruling 59-60 ..." that are to be applied to determine the value of "hard to value" IRA assets?

Revenue Ruling 59-60 applies general principles to consider when valuing these types of assets, summarized as follows:

1. Consider all relevant facts and circumstances affecting the value of the interest.

2. Consider the particular facts and circumstances when selecting and applying the appropriate valuation method.

How Does a Custodian/Trustee Go About Determining the Fair Market Value of These Assets?

1. Do not use "cost" or "book value" when valuing these non-market assets.

2. In some cases, financial institution personnel may be used to value such non-market IRA assets. But this should only be done if such personnel are experienced appraisers, and have reviewed all appropriate IRS rules and guidelines.

3. If choosing an independent appraiser, choose one who is proficient in valuing these types of assets. Review the following points when choosing the independent appraiser (these also apply to internal appraisers):

1. Make sure your independent appraiser is qualified to appraise the asset under consideration.

2. The appraiser should understand and incorporate into his or her work the key judicial decisions concerning appraisals, such as discounts for lack of marketability.

3. The appraiser should have access to secondary market transactions for the applicable asset class.

4. Most important, the appraiser should be independent of the plan and the asset being valued.

Why is Non-Market Asset Valuation a HOT Topic?

In addition to simply meeting the IRS-decreed responsibility to provide correct fair market value information on Form 5498, there is a special need for accuracy for $70^{1/2}$-year-old accountholders who are receiving required minimum distributions from plans that include non-marketable assets.

The FMV is needed in order to determine the required minimum distribution amount for any given year. If the FMV is wrong because IRA assets are undervalued, then an IRA will under-distribute. As custodian/trustees are well aware, there is a 50% penalty for amounts required to be distributed that are not. This can have very negative consequences for BOTH the custodian/trustee and accountholder, who rightfully assumed competence and accuracy when their assets were valued.

Non-IRA Plans

Although we are primarily addressing IRAs, it is equally important that pension asset valuations be done correctly. If not, then participants receiving distributions may either be paid too much, or too little. If values are overstated, then a participant leaving a plan "early" (and paid in cash) will be overpaid. Later participants may consequently receive less then they should.

Undervalued assets on the other hand, may instead benefit the business owner, or other participants who terminate at a later date.

Neither situation is desirable. PD

RMD: Using the $70^{1/2}$ 'Alternative Method'

The revised October 1992 5305/5305-A IRA plan provisions permit the use of the "alternative method" to satisfy minimum distribution requirements. Under this method, the minimum distribution for each IRA must be calculated separately, based on the $70^{1/2}$ elections made for each IRA. These distribution amounts can then be added together by the accountholder to arrive at a total required distribution amount. This total required distribution can be distributed from one or more of the individual's IRA accounts. A distribution need not be taken from every IRA.

Sample Chain of Events

1. Accountholder has three separate IRA plans at three different financial institutions and turns $70^{1/2}$ in 1993.

2. Each institution, as custodian trustee, should obtain the $70^{1/2}$ irrevocable elections from the accountholder. It is not required that these elections be identical at all three of the institutions, but may be identical if the account-holder chooses.

3. Each institution is to calculate the required minimum distribution amount for the IRA plan(s) for which they are custodian trustee. It is NOT recommended that you take on the responsibility of calculating the required minimum amounts for the other IRA plans from other institutions. In addition to exposing the institution to more liability, you are adding needlessly to your responsibilities.

4. The accountholder then aggregates all three required minimum distribution amounts to come up with a total required minimum distribution. This total required minimum distribution amount may be taken from one or more of the IRA plans. If the accountholder decides to take the total required minimum at your institution you only need to be concerned that he or she distributes an amount equal to or greater then the required minimum that you calculated for the IRA plan(s) at your institution. If the accountholder elects to take the total required minimum at one of the other two institutions, then you, as the custodian trustee, need to have a certification from that accountholder stating that the alternative method was used to comply with the required minimum distribution rules.

Summary: When customers elect to use the alternative method for $70^{1/2}$ required minimum distributions, each institution still needs to obtain the $70^{1/2}$ elections and to calculate the required minimum each year for the IRA plan(s) at that institution only. It is not your responsibility to calculate the required minimums for any IRA plans not at your institution. In fact, it is advised that you not take on that added liability and responsibility. PD

Conference Classic IV Offers Added 'Hot Topics' for Pension Professionals

Pending any new legislative changes, topics have been finalized for CWF's Conference Classic IV, our three-day, in-depth IRA and pension workshop July 31 through August 3 at Madden's Resort, near the new corporate offices in Brainerd, Minn.

A comprehensive brochure with details and a full agenda will be available by January 25. Be watching for it in the mail, or call us at 1-800-346-3961 for an advance copy.

Special Topics added to Final Agenda

In addition to the many topics outlined in earlier issues of *The Pension Digest*, we have added the following new segments:

• Valuation of Non-Liquid Assets in IRAs and Pension Plans – Despite the difficulty in determining such asset values, it is vital to accountholders and plan participants that this valuation be done properly, and is the responsibility of the custodian or plan issuer to do it correctly (see related story in this issue).

• Age-Weighted Profit-Sharing Plans – We'll discuss the special characteristics of such plans, and what types of businesses or employers may benefit most. Session includes commentary on Congressional attempts to modify or ban these plans.

• IRA Investments and Prohibited Transaction Concerns – Annuities, securities, certain kinds of property and improper fiduciary relationships can create great compliance headaches. We'll help you assess risk and assist your customers, as well as minimize potential liability for your institution.

Call us for more details on Conference ClassicIV at 1-800-346-3961. PD

New 'IRS Publication 590' Updates Changes to Some PTs and Distributions

The 1993 tax return version of "IRS Publication 590 – Individual Retirement Arrangements (IRAs)" has recently been released.

In addition to the many longstanding provisions, there is also information on changes. These include changes with regard to certain prohibited transactions and distributions from employer plans. The format has also been made more readable by the use of larger type, which has resulted in Publication 590's expansion from 44 to 64 pages.

We will be discussing Publication 590 changes in detail in the February issue of *The Pension Digest*. PD

Potential IRA Prohibited Transactions? Follow These Procedures to Comply

When an institution decides to offer self-directed IRAs, it exposes itself to many additional responsibility and liabilities. The added responsibilies lie in the fact that, as custodian or trustee, that institution has a duty to file 1099-Rs and 5498s with the IRS each year and thereby report distributions (and prohibited transactions), contributions, and fair market values. The liability with self-directed IRAs results from the complicated prohibited transaction rules.

What Steps Can an Institution Take to Help Limit Prohibited Transaction Liability Exposure?

1. When in doubt, get a written opinion from the accountholder's attorney.

When an accountholder comes to the institution with an investment direction that has the appearance of a possible prohibited transaction, the institution has the right to require the accountholder to provide an attorney's written opinion if it feels it would expose itself to undue liability by allowing the investment. This written opinion should certify that it is the attorney's opinion that the proposed transaction is not a prohibited transaction, and that if it is found to be so, the accountholder and/or his or her attorney will accept full responsibility and liability for this transaction.

2. Have the accountholder sign a hold-harmless agreement.

The institution should also have the customer sign a hold-harmless agreement stating that he or she will not hold the institution responsible for any consequences of this transaction. In the future, if the IRS does deem this transaction a prohibited transaction, the bank would be able to deflect some of the blame by reminding the customer that he or she agreed that the bank would not be responsible.

3. Put the questionable investment in a separate IRA plan.

Even after receiving an attorney's opinion and a signed hold-harmless agreement, the bank should put the investment into a separate IRA. By opening a new IRA and putting only that one investment in the IRA, the bank is protecting a customer's other IRA assets. If the IRS were to ever declare this transaction prohibited, the entire IRA would be deemed distributed as of the first day of the tax year. However, if the IRA consists of only that one investment, the consequences of the distribution would be less extreme than if the investment had been placed with other IRA assets.

As an IRA fiduciary it is sometimes extremely difficult to avoid all exposure to liability. But by taking precautionary measures such as these, the institution can attempt to reduce the level of exposure. PD

✔ ✔ ✔ Check It Out ✔ ✔ ✔

The Pension Digest invites your questions and comments. Please address to: "Check It Out," Collin W. Fritz and Associates, Ltd., P.O. Box 426, Brainerd, MN 56401.

Question: My customer has both an IRA and a profit sharing Keogh plan with us. Her required minimum distribution amount for the IRA for 1993 is $1,325. Her required minimum distribution amount for the profit sharing Keogh for 1993 is $3,500. In September she withdrew $5,000 from her profit sharing Keogh. Must she still withdraw the $1,325 from her IRA or can she consider the excess Keogh amount to cover the IRA portion?

✔ Answer: She must withdraw the $1,325 from the IRA or certify to you that she has withdrawn this amount from another IRA. IRA Notice 88-38 allows a person to withdraw from just one IRA the aggregate required minimum distribution amounts from multiple IRAs. This notice does not provide for the same treatment for IRAs and Keoghs. They are different types of plans and it is CWF's opinion that the IRA regulation does not authorize the offset approach. We have never seen the IRS address this issue in writing.

Question: If I have multiple profit-sharing plans, can I use the IRA approach and take an aggregate required distribution from only one of the profit-sharing plans?

✔ Answer: Similar to the answer to the question above, this may not be done. Not only may the offset approach not be used between an IRA and another type of qualified plan, , but the offset approach does not apply BETWEEN two identical, or similar, qualified plans. PD