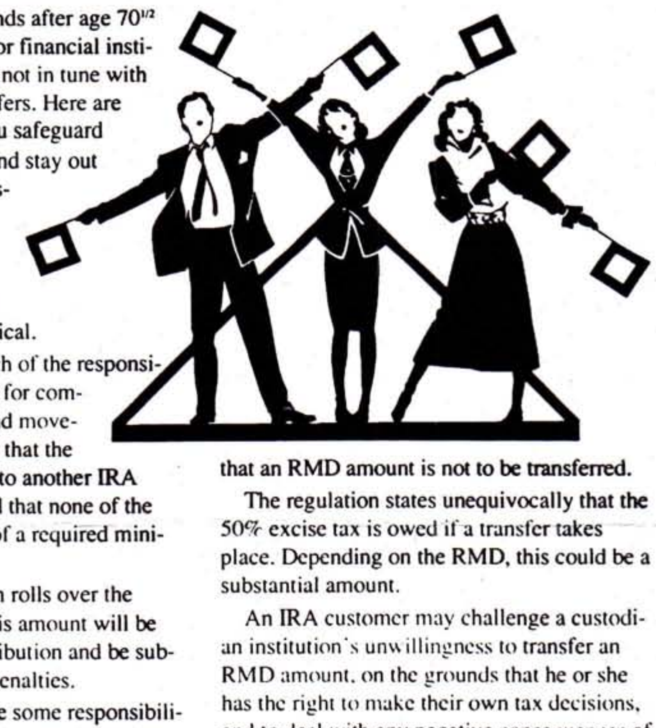
THE Pension Digest

Published Since 1984 | Collin W. Fritz and Associates, Ltd., *"The Pension Specialists"* | February, 1994

Also in this issue

Avoiding the $70^{1/2}$ RMD-Transfer 'Danger Zone'



Movements of IRA funds after age $70^{1/2}$ can pose problems for financial institutions and accountholders not in tune with the rules of IRA fund transfers. Here are some guidelines to help you safeguard your customers' interests and stay out of trouble with both the customer and the IRS.

The rules for IRA transfer and IRA rollover transactions for accountholders $70^{1/2}$ years old are not identical.

IRA rollovers place much of the responsibility on the accountholder for complying with the rules of fund movement, specifically ensuring that the IRA funds are deposited into another IRA account within 60 days and that none of the rolled-over funds are part of a required minimum distribution (RMD).

If the accountholder then rolls over the RMD back into an IRA, this amount will be considered an excess contribution and be subject to the accompanying penalties.

If anything, there may be some responsibility on the part of the institution receiving the funds to attempt to verify that no funds which are part of an RMD are part of the transaction. This can be readily done through use of a rollover certification form.

But IRA transfers place a burden squarely on the shoulders of the pre-transfer custodian institution, the institution releasing the funds in the transaction. The rules are very specific, stating that an RMD amount is not to be transferred.

The regulation states unequivocally that the 50% excise tax is owed if a transfer takes place. Depending on the RMD, this could be a substantial amount.

An IRA customer may challenge a custodian institution's unwillingness to transfer an RMD amount, on the grounds that he or she has the right to make their own tax decisions, and to deal with any negative consequences of an RMD rollover transaction in their own way. The pressure may be compounded by advice from the new custodian – anxious for the funds – telling the customer that you, the present custodian, could transfer the RMD amount if you so chose. An IRA accountholder is especially likely to object to a pre-transfer distribution if

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QP and SEP Amendment Guidelines for OBRA '93

Guidance for amending qualified plans and simplified employee pension (SEP) plans to comply with the Omnibus Budget Reconciliation Act (OBRA) of 1993 has been given by the IRS, in Revenue Procedure 94-13, officially released Jan. 18, 1994.

Behind this amending need is OBRA 1993's reduction of the amount of compensation that can be taken into account for QP and SEP contribution and testing purposes. The amount is down from the former maximum of $200,000 (1993 index figure $235,840) to $150,000. This $150,000 amount will also be indexed, but only in $10,000 increments.

The first of these increases (to $160,000) will not take place until annual cost-of-living adjustments total $10,000. Thereafter, the indexed maximum amount will be rounded down to the next lowest multiple of $10,000.

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

Taxability of IRA Distributions

When a person takes a withdrawal from an IRA, a common question is, "What part of the withdrawal is, or is not, taxable?"

Generally, the entire distribution from the IRA will be subject to ordinary income taxes. IRA distributions do not receive any special tax treatment such as income averaging or capital gains. It is possible, however, that a part of an IRA distribution may not be subject to income tax. This determination depends on whether or not the individual has ever made any nondeductible IRA contributions.

If only deductible IRA contributions were made, the entire portion of each withdrawal from the IRA will be subject to ordinary income taxes. If, however, the accountholder made some nondeductible IRA contributions, a portion of each withdrawal will not be subject to income tax.

While pre-$70^{1/2}$ IRA accountholders may take voluntary distributions, when an IRA accountholder reaches $70^{1/2}$, they have no choice but to begin taking distributions from their IRA, regardless of the deductible/nondeductible status of their contributions and the consequent taxable/nontaxable status of their distributions.

The part of the distribution that represents nondeductible contributions will not be taxed. An accountholder is not permitted to remove only nondeductible contributions, however.

Generally, the entire distribution from the IRA will be subject to ordinary income taxes. IRA distributions do not receive any special tax treatment such as income averaging or capital gains.

Contrary to the writings of some financial columnists (e.g. Susan Bondy, "Bondy on Money"), there is no ability to withdraw nondeductible contributions apart from deductible, and therefore no benefit to keeping such contributions segregated, or separate, in order to separately withdraw contributions that won't be taxed.

Each contribution consists of partly nondeductible contributions, partly deductible contributions and partly interest. That portion of the withdrawal that is attributable to deductible contributions and interest will be taxable. When nondeductible contributions have been made, the accountholder will have to apply a formula to the distribution amount to determine the nontaxable portion. This formula is explained in IRS Publication 590.

Additionally, this formula is contained in IRS Form 8606. This form must be filed when the accountholder takes distributions from his IRAs and has made nondeductible contributions in the past. It must be filed even if the distribution is made from an IRA that has never received a nondeductible contribution if the accountholder ever made a nondeductible deposit to any IRA they maintain.

The ratio of their total nondeductible contributions to the total IRA account balance for all their IRAs will be used to determine which portion of the distribution is not taxable. Again, this calculation is made on IRS Form 8606.

In addition to calculating distribution taxability, Form 8606 is also used to keep track of the nondeductible contributions the individual has made in the past. It must be filed whenever a nondeductible contribution is made.

When Form 8606 is filed, the accountholder must retain that year's tax return until all IRAs are entirely distributed. This is the only way the accountholder will have to track the total nondeductible contributions that have been made. Because of the requirement that Form 8606 be retained, there is no benefit for the accountholder to maintain separate IRAs for deductible and nondeductible contributions. PD

Proposed Changes to Spousal IRA Rules

A bill introduced in Congress in February 1994 would, if enacted, change the spousal IRA contribution limits.

The proposed bill would allow single-income married couples to contribute up to $4,000 per year to their IRA accounts. The effect of this bill would be to raise the current spousal IRA maximum from $2,250 to $4,000 per year.

This proposed change would not affect the current IRA deductibility rules. Married couples who participate in a retirement plan at work would still face the income limits for determining deductibility. These limits for married couples who file a joint return state that if the couple has an Adjusted Gross Income (AGI) of $50,000 or more, they are not entitled to any IRA deduction.

If their AGI falls between $40,000 and $50,000 they would be entitled to a partial deduction. If their AGI is below $40,000, or if neither participate in an employer-sponsored plan, they could deduct the entire amount of their IRA contribution.

The proposed bill has bipartisan support in both the House and Senate and has been endorsed by both liberal and conservative factions. It may, however, face an uphill battle in Congress even with this support.

Sponsors estimate that enactment would result in a $105 million tax revenue loss over a five-year period. The sponsors have not specified any revenue source to pay for this loss. Current Congressional practice now bars any new legislation that would result in a loss of revenue without an offset somewhere else in the budget.

Rep. Nancy Johnson, R-Conn., the chief sponsor of the bill, intends to request hearings even though no offset in the budget has been offered. Some feel that Congress may pass the bill without budget offset because of the strong support it has gained.

The Pension Digest will track this bill and keep readers abreast of its progress. PD

Follow these Instructions for Use of New Form 945

As described in past issues of *The Pension Digest*, new Form 945 is now to be used to report – annually – withholding from IRA distributions. But trouble has arisen in the use of the Form 8109 "coupon" used when withholding is deposited in a federal reserve bank.

The Form 8109 coupon books currently available do not have a box to be checked when the deposit is for Form 945 distribution withholding. According to the IRS, new 8109 coupons will not be issued to institutions until old stock is used up.

Institutions are being instructed to deposit pension withholding under the old Form 941 payroll deposit schedule, but to report the deposit using a separate Form 8109. Institutions are to check the box on the 8109 marked "Schedule A." This is an obsolete schedule, and marking it will tell the IRS that this is a Form 945 (pension withholding) deposit. PD

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their IRA assets are non-cash, such as securities in a self-directed IRA account.

The logical question may be, "If a customer is willing to assume the tax consequences, why not allow them to transfer their entire balance, including the RMD portion?"

Our answer is that a customer's acceptance of consequences may change with the arrival of a bill from the IRS for 50% of the RMD amount. Memory of custodian warnings and statements of personal responsibility can suddenly dim, in the customer's desire to find someone to share the unpleasant tax consequences.

How About a Hold-Harmless Agreement

We can give no guarantees as to the effectiveness of a hold-harmless agreement and believe that the most conservative approach is to not transfer an RMD amount. But a hold-harmless agreement, in which the customer expressly instructs you to make the transfer and assumes responsibility for the consequences, in full knowledge of the regulation, would be preferable to simply transferring the funds.

The problem with such a hold-harmless agreement is that in some situations a fiduciary cannot escape liability by transferring it to another party, even with that party's consent.

The 'Alternative Method' Argument

An especially savvy accountholder may cite the "alternative method." which allows a person to satisfy IRA minimum distribution requirements by taking distributions from one or more – but not all – accounts, to satisfy their total RMD. In typical non-transfer situations, when a distribution is due to be taken, the accountholder has only to certify that their RMD was taken from another account(s).

Does this work in a transfer situation? This is a gray area. The adoption of the "alternative method" for satisfying a customer's RMD came AFTER the writing of the proposed regulation that prohibits the transfer of Required Minimum Distribution amounts. There has been no direction from the IRS on how these two subjects interrelate, or if an "alternative method" certification would free an institution to transfer IRA funds without an RMD being taken from that account.

We do feel that a transfer in such a situation would be appropriate. We must make a clear distinction, however, that you require that the RMD amount has ALREADY BEEN TAKEN from another account, not that it "will be." IRA custodians should remember that most plan agreements give them discretion as to whether or not they will transfer IRA funds. You do have the right to say "no transfer." But in most day-to-day IRA administration situations, this is rarely exercised for fear of incurring the wrath of an accountholder.

Another Option: A Transfer/Rollover Combination

Another option is to split the IRA account funds. You could issue a distribution check for the RMD amount payable to the accountholder and the remainder issued as a second check in the name of the receiving custodian, a true transfer.

The responsibility for the disposition of these distributed funds will be clearly in the hands of the accountholder. If he or she rolls them over to the new custodian, they will be liable for an excess contribution.

Will IRS Waive RMD Transfer Rule?

There may be circumstances in which the IRS would waive the 50% excise tax on an RMD amount transfer. However, it has been our experience that it is most likely to do so when such a transaction is inadvertent or unintentional. A "knowing violation" is not a good candidate for an IRS penalty waiver.

A 50% RMD penalty may be a very costly consequence for an insistent customer executing an IRA transfer. A financial institution should do everything it can to avoid being a party to such a mistake. PD

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For example, if one or more annual cost-of-living increases raises the indexed amount to $157,000, the cap remains at $150,000. If subsequent increases bring the total to $162,000, this is rounded down to $160,000.

With limited exceptions for certain collectively-bargained, government and tax-exempt organization plans, these compensation cap changes are effective for plan years beginning on or after Jan. 1, 1994.

However, for SEPs and qualified plans having a non-calendar, fiscal-year plan cycle, the compensation limit that applies is that limit in effect for the calendar year in which the plan year begins. For plan years that do not begin on Jan. 1, 1994, the new limit will apply commencing with the beginning of the next plan year.

Cap Reduction Is Not Considered a Regulation Violation

Prior to the issuance of Rev. Proc. 94-13, there was some uncertainty over whether a reduction in the compensation cap amount might violate the anti-cutback provision of Code section 411(d)(6). This Rev. Proc. has clarified that if amendments are made in a timely fashion, there will be no violation.

Behind this amending need is OBRA 1993's reduction of the amount of compensation that can be taken into account for QP and SEP contribution and testing purposes.

Furthermore, there is to be no reduction in accrued benefits for those employees who will be affected by the reduced compensation limit.

Amendment Options

Qualified Plans and SEP Prototypes

Qualified plans and SEP prototypes may be amended using either model amendment language provided by the IRS or privately drafted non-model amendment language. For SEP amending, only the first two paragraphs of the model amendment are necessary.

SEPs Using IRS Forms 5305-SEP and 5305A-SEP

According to Rev. Proc. 94-13, only the model amendment language may be used to amend SEP plans based on 5305-SEP and 5305A-SEP plan language. The Rev. Proc. states that model SEP plan "sponsors" must adopt the first two paragraphs of the model amendment language in the amending procedures. However, these IRS model plans do not have "sponsors" in the same sense that qualified plans and SEP prototypes do. It may be assumed, however, that it is the IRS' expectation that financial institutions providing the model SEP plans to employers will also provide the model amendment.

Amendment Deadline

For most plans, the deadline for amending is the last day of the first plan year that begins on or after Jan. 1, 1994. For most plans, therefore, this deadline would be Dec. 31, 1994.

Information on amendments prepared by *The Pension Digest* publisher Collin W. Fritz and Associates, Ltd., to comply with this requirement may be obtained by calling the CWF Consulting Department at 1-800-346-3961. PD

IRS Announces Cost-of-Living Adjustments

Unlike IRAs, whose contribution and deductibility limits have remained static through the years, many other retirement plans have a mechanism by which contributions, caps and employee compensation amounts change from year to year. This mechanism is known as indexing.

The IRS in News Release 94-3 has released its 1994 adjustments as follows:

	1992	1993	1994
Elective (Salary) Deferral Limit	$8,728	$8,994	$9,240
SEP Minimum Compensation Threshold	$363	$385	$396
SEP and Qualified Plan Maximum Compensation Cap	$228,860	$235,940	*$150,000
* – Reduced by Omnibus Budget Reconciliation Act of 1993.			
Section 415			
Defined Benefit Limit	$112,221	$115,641	$118,800
Defined Contribution Limit (The annual defined contribution plan limit is $30,000 as indexed and will not change until the defined benefit amount exceeds $120,000.)	$30,000	$30,000	$30,000
Excess Distribution Tax Threshold	$140,276	$144,551	$148,500
Top-heavy plans			
Officer Amount	$56,111	$57,821	$59,400
Top 10 Owner Group (Has more than one-half percent and the largest ownership interest and income in excess of $30,000.)	$30,000	$30,000	$30,000
1% Owner (Having annual compensation in excess of $150,000.)	$150,000	$150,000	$150,000
Highly-Compensated Employees (Compensation as indexed)			
Compensation in excess of $75,000	$93,518	$96,368	$99,000
Compensation in excess of $50,000 and was in the top-paid group	$62,345	$64,245	$66,000

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✓✓✓ 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: We have an IRA account in which a prohibited transaction has occurred. The accountholder wants us to sell the asset that caused the prohibited transaction and place the proceeds back in the IRA. Can we do this, and does this "fix" the prohibited transaction?

✓ Answer: Unfortunately, the answer to both questions is NO. Once a prohibited transaction occurs within an IRA, the result is immediate and incurable. The IRA is disqualified and deemed distributed in its entirety as of the first day of the year the transaction occurred. The legal responsibility of the custodian/trustee is to distribute the entire IRA balance and report the distribution on a Form 1099-R with a distribution code #5. Failure to file correct 1099-R reports can result in a $25 per day penalty up to a maximum $15,000 per year for the IRA custodian or trustee. This action will not endear you to your customer. But it is the only course to take if you wish to avoid a compliance violation. PD

Comptroller of Currency Requests National Banks Help Inform Customers on Deposit, Investment Differences

Too many American consumers of banking services are unaware of the differences between a deposit and an investment, particularly with respect to insured status, according to the Office of the Comptroller of the Currency. This includes IRA as well as other deposit customers.

Because of this, national banks are being asked to provide customers with information contained in a brochure now being made available from the C of C's Consumer Information Center, P.O. Box 100, Pueblo, CO 81002. This brochure describes in simple-to-understand terms the crucial differences between insured deposits and mutual funds, annuities and other non-deposit investments also offered by financial institutions. Other answers about investing or investment products are also included.

In addition, the publication also describes the role that the U.S. government plays in regulating deposits and investments. It explains different types of investment products as well as typical programs and fees encountered with financial institutions and other investment sources.

National banks planning marketing programs for investments are encouraged to include the contents of this brochure in their program.

A sample brochure is available at the above address and can be reproduced by the institution. Ask for the brochure entitled "Deposits and Investments: There's a Critical Difference." Private vendors may also be supplying this brochure for purchase. PD

What Type of Retirement Plans do Banks Offer to Employees?

A 1993 survey of approximately 300 financial institutions (commercial banks, savings banks and savings and loans) gives us an answer.

Commercial banks indicated that they use either profit-sharing or 401(k) plans 77% of the time (47% 401(k) plans and 30% profit-sharing plans).

Savings banks (37%) and savings and loans (34%) also used either profit-sharing or 401(k) plans. Savings banks and savings and loans used defined benefits plans much more often than commercial banks. Savings banks used defined benefit plans 55% of the time and savings and loans 49%.

About 28% of all the institutions surveyed offered more than one type of plan. PD