THE Pension Digest

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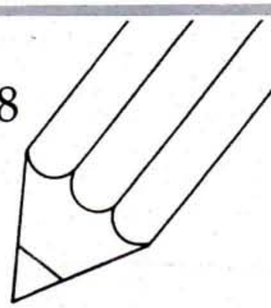
Some IRA Data Processors Still Failing to Provide Separate 5498 Reporting for Inherited Accounts



... taxation, minimum distribution issues demand segregating accounts, multiple 5498s

As financial institutions carried out their Form 5498 IRA reporting duties prior to the May 31 deadline, it became apparent from many consulting calls that some data processing service providers had not furnished 5498 forms in the fashion they should. Specifically, some data processing providers were still preparing single 5498 forms for customers who have IRAs from several sources, such as their own IRA, plus one or more inherited accounts. Instead of providing separate 5498s for each account, many of these customers have had a single Form 5498 prepared with aggregated account information.

While this discussion here will not alter the fact that some reporting may have been done incorrectly, it is important to analyze your institution's situation now, in order that data processors may be instructed as to changes they must make in their programming for next year. It may also be advisable to consider corrected reporting now for those customers who fall into this category.

There are two important reasons for the use of separate 5498 forms for inherited accounts. The first has its origins in the Tax Reform Act of 1986. TRA '86 made possible nondeductible, or after-tax, IRA contributions. These nondeductible contributions are not taxed at the time of distribution, because they have already been taxed in the year of contribution. Their earnings are taxed at distribution, however, as are any deductible contributions made to the same accounts. In order to determine which portions of an IRA's total assets will be taxed upon distribution, these after-tax contributions – known as "basis" – must be tracked throughout the life of an IRA.

The IRS has made the determination that it is simplest to track deductible contributions and nondeductible amounts, if inherited accounts are not aggregated with owned accounts for recordkeeping. As a result, separate 5498 (contribution) and 8606 (nondeductible contribution recordkeeping) forms are used for every IRA that has a different source. Its effect is a positive one for IRA beneficiaries, ensuring that they do not pay taxes on inherited amounts for which taxes have already been paid by a decedent.

The 1993 IRS Publication 590 (page 30) contains the following description of IRAs having basis (nondeductible contributions):

"IRA WITH BASIS. If you inherit an IRA from a person who had a basis in the IRA because of nondeductible contributions, that basis remains with the IRA. Unless you are the decedent's spouse and choose to treat the IRA as your own, you cannot combine this basis with any basis you have in your own IRA, or any basis in IRAs you inherited from other decedents. If you take a distribution from an inherited IRA and your IRA, and each has basis, you must complete separate Forms 8606 to determine the taxable and nontaxable portions of those distributions."

An example: Laura Gherls has her own IRA with a balance of $18,000. She has never made a nondeductible contribution to this account. David Gherls, her father, died in 1993; he had an IRA with a balance of $30,000, a basis of $8,000 and Laura was his beneficiary. Maria Gherls, her mother, died in 1992; she had an IRA with a balance of $35,000, a basis of $10,000 and Laura was her beneficiary. Marlene Gherls, her sister, died in 1993; she had an IRA with a balance of $24,000, a basis of $4,000 and Laura was her beneficiary.

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"Old" SEP Forms May be Used Until June '94

Although revised Simplified Employee Pension (SEP) forms have been issued by the IRS, employers are being informed (per IRS Announcement 94-52) that they may use their existing documents until June 30, 1994. These are the 5305-SEP (regular SEP) with 4/30/94 expiration date, and 5305A-SEP (salary reduction SEP) document with 3/31/94 expiration date.

Those employers who wish to continue using IRS "model" plan documents rather than a private pension provider's prototype SEP agreements, must adopt one of the new model plan forms no later than March 31, 1995, and distribute it to all eligible employees.

In the May Pension Digest, we discussed the reasons for the revised SEP forms, chief among them being the reduction in the amount of employee compensation that can be considered when making a SEP contribution. The Omnibus Budget Reconciliation Act of 1993 reduced this maximum from $200,000 to $150,000.

For samples, or to purchase the new SEP documents, please call our Customer Service Department at 1-800-346-3961. PD

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The three inherited IRAs need to be separately identified as such: Laura as beneficiary of David; Laura as beneficiary of Maria; and Laura as beneficiary of Marlene. Plus, she has her own IRA.

The concept is: a beneficiary inherits the deceased accountholder's basis as well as the IRA funds. It is only fair that the beneficiary should not have to pay income tax on that portion of the IRA funds for which the accountholder received no tax benefit (i.e. no deduction). The IRS has clearly adopted the approach that a person will not be able to "merge" IRAs from different sources for income tax purposes.

The second reason that inherited IRA accounts are reported on separate forms and not aggregated with other IRAs, pertains to required minimum distribution options. There is a great difference between IRA minimum distribution options for a person with their own IRA, versus a person who is the beneficiary of an inherited IRA, unless they are a spouse beneficiary and therefore have the option to treat the decedent's IRA as their own. Similarly, there are distribution differences between inheriting an IRA for which distributions have already begun, versus inheriting an IRA not yet in distribution.

Beneficiary Options

	Accountholder Dies Before Required Beginning Date	Accountholder Dies After Required Beginning Date
Spouse	Treat as own.	Treat as own.
	5-year payout. Life distribution, based on spouse's life expectancy. Begin distribution by December 31 of year accountholder would have attained 70 1/2.	Continue or accelerate payout schedule established by accountholder.
Nonspouse	5-year payout. Life distribution, based on beneficiary's life expectancy, BUT BEGINNING BY DECEMBER 31 OF THE YEAR FOLLOWING THE YEAR OF ACCOUNTHOLDER'S DEATH.	Continue or accelerate payout schedule estabished by accountholder.

Because of the significantly different rules governing these different minimum distribution circumstances, aggregating all inherited IRAs as well as one's own IRA(s) is not permitted. Therefore separate Forms 5498 are required. If your data processing service provider is not handling these forms in this fashion, this must be changed.

Corrected 5498 Forms

The penalty for failing to prepare a needed Form 5498 is $50 per form that was not prepared. We feel that in this circumstance it is better late than never, and would recommend that you prepare and file additional Forms 5498 for every customer who has inherited IRAs in addition to their own account, or multiple inherited IRAs, if their 5498 amounts were aggregated. PD

Excess Distributions and Excess Retirement Accumulations –

For Some, Delaying IRA Distributions May Be Costly Since Additional Taxes Will Be Due

Many IRA accountholders have the belief that they should always delay distributions as long as they can (i.e. wait until the 70 1/2 year) and to never withdraw more than their required minimum distribution amount, in order to lessen or defer income taxation of accumulated IRA funds and other pension assets. This has become a "pat" answer because IRA distributions are taxed in the year received, and the potential negative impacts include higher taxation rates for some recipients, and/or greater taxation of Social Security benefits.

However, this philosophy may not always be good advice for those individuals with very substantial IRA and other pension balances, because one or more special taxes may apply in addition to including the distribution in gross income and being subject to ordinary income taxation.

The Internal Revenue Code requires most persons who receive annual retirement distributions of more than $150,000 (or $112,500, as indexed, if greater) to pay a 15% tax on the distribution amount exceeding $150,000 (or $112,500, as indexed, if greater). For 1994 the $112,500 has been increased to $148,500. In 1995 the new indexed amount will be used rather than the $150,000.

For example, Sally Martin, age 61, in 1994 withdraws $180,000 from an IRA with a total balance of $1,500,000. Sally Martin will be required to pay a special excise tax for 1994 of $4,500, or 15% times ($180,000-$150,000). Form 5329 in combination with Form 1040 is used to calculate and report the tax owing.

Sally Martin most likely will not want to let her account balance grow so large that when it is time for her to take a required minimum distribution she will have to pay the 15% excise tax. That is, she will not want her RMD amount for any year to be more than $150,000 (as indexed).

The Internal Revenue Code also imposes a special tax on an individual's estate if he or she has IRA account balances and other pension account balances which are "too large" at the time of their death (i.e. excess retirement accumulations). This tax is equal to 15% times the resulting sum when the account balance at the time of death is reduced by an amount determined by multiplying $150,000 (as indexed) by an annuity factor. This annuity factor is based upon the accountholder's age in the year of death plus the current interest rate.

This 15% tax assessed against an estate can be harsh since the annuity factor which is used is based upon a <u>single life expectancy</u> and not a joint life expectancy as may be used for purposes of the 50% RMD excise tax.

For example, Dallas Godfrey died in 1994 at the age of 73. His IRA account balance was $1,375,000. He had rolled all of his various qualified plan account balances into this IRA account. He had commenced his required minimum distributions using a joint/nonrecalculation method to determine the applicable yearly life expectancy factor. His sole beneficiary is his daughter, Annie, who is 48 in 1994. Therefore, the special MDIB tables will be used for RMD purposes while he is alive. His estate will pay an excise tax equal to 15% times the difference between his account balance ($1,375,000) and the amount determined by multiplying the $150,000 times the applicable annuity factor of 7.4811 (based on age 73 and an interest rate of 6%). The difference is $252,835, so the excise tax is $37,925. This is a substantial tax.

Note that Dallas Godfrey's required minimum distribution amount for 1994 is $58,511 ($1,375,000 ÷ 23.5). This amount is well less than the $150,000 limit.

If he wishes to avoid the possibility of the assessment of the 15% excise tax upon his death, he may wish to withdraw more than $58,511.

There are special rules which may apply to change the impact of these two special 15% taxes.

Rule #1. The 15% excise tax is reduced by any tax on premature distributions that applies to the excess distributions.

Rules #2. Not all distributions are subject to the excess distributions tax. The fol-

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Excess Distributions—*Continued from page 2*

lowing are not subject to the 15% tax:

- Distributions to a beneficiary after the death of the IRA owner (or employee in the case of employer plans),
- Distributions that are rolled over,
- Distributions that represent nondeductible contributions,
- Corrective distributions of excess deferrals under a salary reduction arrangement (or a similar qualified plan),
- Corrective distributions of excess aggregate contributions, and
- Corrective distributions of excess annual additions.

Rule #3. A special rule applies to an individual who receives a lump sum distribution and elects 5/10-year averaging. The $150,000 (as indexed) amount increases to $750,000.

Rule #4. A special limit applies to certain individuals. The following excerpt from IRS Publication 590 summarizes this rule.

On a return filed for a tax year ended before January 1, 1989, you could have chosen not to pay the 15% tax on the part of any distribution that is related to your accrued benefits on August 1, 1986. This rule ***applies only if*** *the accrued benefit as of August 1, 1986, exceeded $562,500.*

However, if you made this choice to exclude from the tax on excess distributions a distribution amount allocable to your August 1, 1986, benefit accruals, your other retirement distributions are subject to the tax to the extent they are more than $148,500 for 1994 (instead of $150,000). Furthermore, this $148,500 amount is reduced (but not below zero) by any distributions received during the year that are allocable to the August 1, 1986, benefit accruals.

If you did not elect to apply this rule, then the 15% tax will apply to the part of the distribution that exceeds $150,000.

Rule #5. The estate of the decedent will not need to pay the 15% tax if the surviving spouse elects not to have this special estate tax apply, However, these funds then become subject to the 15% excise tax if the surviving spouse receives an excess distribution.

In order to gain this special treatment, it is required that the spouse be virtually the sole beneficiary of all of the IRA and pension account balances. There is a de minimis exception. The spouse will not lose the ability to make this special election if one or more persons other than the spouse are beneficiaries of a de minimis portion. The statute and temporary regulation do not define what amount or percentage is considered to be de minimis. The Conference Committee indicates that an amount will not be considered to be de minimis if it exceeds 1% of the decedent's retirement accumulation.

Rule #6. There is a noncommingling rule which applies to surviving spouses. The following excerpt is from the temporary regulation.

A. (a) *General rule.* If a surviving spouse rolls over a distribution from a qualified retirement plan or an individual retirement plan of the decedent to an individual retirement plan (IRA) established in the spouse's own name with the rollover contribution and no other contributions or transfers are made to the IRA receiving the rollover contribution, distributions from such IRA will be excluded in determining the spouse's excess distributions and the value of the IRA will be excluded in determining the spouse's excess accumulation. If the surviving spouse rolls over a distribution from a qualified retirement plan or IRA of the decedent to an IRA for which the spouse has prior contributions or makes additional contributions to the IRA receiving the distribution, distributions from the IRA will be included in determining the amount of the excess distributions received by the spouse for the calendar year of the distribution and the value of the IRA at the applicable valuation date will be included in determining the spouse's excess accumulation.

Summary.

The purpose of this article has been to illustrate the importance of considering the two 15% excise taxes when structuring distributions from IRAs and other retirement plans. Please call if you have further questions. PD

IRS Proposes More Uniformity in 1099, 5498 "Substitute" Statements

As many IRA administrators are well aware, Form 1099 (distribution) and 5498 (contribution and fair market value) statements to accountholders may be made on "substitute" statements rather than actual IRS forms. These substitutes are required to contain specific items of information (among these the statement "This information is being furnished to the IRS).

However, despite meeting the information requirements, the format used can vary greatly in terms of information placement, and the instructions provided to the IRA accountholder for use of this information. This, in the eyes of the IRS, has caused difficulty not only for IRA accountholders, but also for tax preparers, and the IRS itself in locating and extracting needed data from the forms.

In order to minimize variations and these accompanying difficulties, the IRS has proposed in Announcement 94-44 the following requirements, which would be effective for 1995 tax year reporting, and therefore first used on Form 1099 statements furnished to customers by January 31, 1996:

* Tax year, form number and form name must be displayed prominently together in one area of the substitute form, i.e. upper right, upper left, etc.

* Instructions provided for use of the information would contain only the instructions for the form(s) provided to the customer. For example, an instruction sheet covering 1099-DIV, 1099-INT, and 1099-R, etc., could not be used unless all these forms were being provided to the customer. If only the 1099-R is provided, only 1099-R instructions could be provided.

* All copies must be clearly legible.

* All copies must be photocopy-able.

* "Fading" of carbon transfer inks must not affect legibility or ability to photocopy.

Compliance checks of selected statement providers will be made by the IRS to ensure that they are meeting the substitute statement requirements. However, no penalties have been established at this time. PD

Two 1099-Rs Needed When Distribution is Part Direct Rollover, Part RMD

The IRS has issued a clarification to resolve uncertainty over the 1994 Form 1099-R instructions for reporting minimum distributions (under section 401(a)(9) of the Internal Revenue Code).

The consequence of this clarification is that two 1099-R forms must be filed if a distribution is in part a Required Minimum Distribution (RMD), and in part a direct rollover. The IRS clarification is contained in Announcement 94-46, and reads:

> ... "For example, if part of a distribution is a minimum distribution required by section 401(a)(9) and part is a direct rollover, two forms must be filed – one for the part that is a direct rollover and one for the part that is the minimum distribution."

An example may help clarify this point: Dow Jones, age 72, is retiring as vice president of a family-owned business. He has $50,000 of assets in a quali-

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Form 5500, Schedule P Filing Deadline Approaching

Although roughly two months away, pension plan administrators and financial institutions that assist them are reminded that the deadline for filing the annual return for most pension benefit plans is July 31. There *are*, however, exceptions to the July 31 deadline. If a pension benefit plan has a fiscal rather than a calendar plan year, the deadline is not July 31, but "... the last day of the 7th month following the end of the plan year," according to the IRS instructions.

Forms that come under this deadline for furnishing to the IRS are Forms 5500, 5500-EZ or 5500-C/R. The form to be used for a given plan is determined by the number of its participants. The primary focus of this article will be the so-called "one-person" plans, which file the Form 5500-EZ (multi-participant plans with up to 99 participants file Form 5500-C/R, and those with 100 or more participants file Form 5500).

In actual practice, a "one-person" plan may include more than one individual. It may also include a business owner's spouse, or multiple partners in a business partnership, or such partners and their spouses. Plans may include defined-benefit, profit-sharing, money-purchase, stock bonus, employee stock ownership (ESOP), or 401(k) plans. Testing to determine if a plan qualifies as a one-person plan is as of the first day of the plan year. This in effect gives the plan up to a one year "grace period" to remain technically a one-person plan, even if other workers become participants during the plan year.

Who Must File

If an employer has one or more one-person plans whose balance or aggregate balance is less than $100,000 at the end of the plan year, no Form 5500-EZ need be filed. The only exception to this is the termination of a one-person plan. In such cases, even a plan with less than $100,000 in assets must file a Form 5500-EZ for the final plan year.

If a single one-person plan has more than $100,000 in assets, a Form 5500-EZ must be filed. Similarly, if two or more one-person plans have an aggregate of $100,000 assets, a Form 5500-EZ must be filed for each plan, even if neither has a $100,000 balance individually.

Filing Extension Possible

If an extension beyond this deadline is desired, an additional 2 1/2 months grace period may be obtained by filing Form 5558 and receiving IRS approval. One-person plans, however, have a simpler option. If such businesses have received an extension of the deadline for filing their federal income tax return, they automatically have until that extended date to file their Form 5500-EZ.

They have only to meet the following conditions: 1) plan year and tax year must coincide, 2) the tax filing extension received is for a date later than the normal Form 5500-EZ filing deadline, 3) a copy of the IRS' income tax filing extension is included with the filing of the Form 5500-EZ when it is filed.

Only one type of extension may be used for a plan year, however. If the "automatic" tax filing deadline extension is used, no additional 5500-EZ filing extension is possible, even by using the extension application Form 5558.

Form 5500-EZ Reporting Penalties

The penalty for failure to file a 5500-series form is $25 per day, up to a maximum of $15,000. This would be the responsibility of the business itself (the plan administrator), unless it had contracted with a financial institution for preparation and filing of its Form 5500-EZ. Few institutions currently do so, but as a customer service should send a reminder notice to such customers.

Where to File Form 5500-EZ

The Form 5500-EZ should be filed by sending to:

Internal Revenue Service Center
Andover, MA 05501

Filing Amended 5500-EZ Returns

If an amended return is found to be necessary, the box at the top of the form entitled "an amended return" should be checked, the corrected items should be circled for easy identification, and the form submitted to the same IRS location.

Schedule P

One of the key reporting requirements associated with the Form 5500-series is submitting the Schedule P. This is the area in which a financial institution is almost certain to be involved, as plan sponsor, plan trustee, or both.

The purpose of Schedule P is to set in motion the three-year statute of limitations period for the pension information contained on the Form 5500 series returns. It is very important, not only for a customer but also for a trustee or custodian institution, since it provides protection against plan errors for which the trustee or custodian could in some circumstances bear some liability.

However, Schedule P is by IRS instruction to be filed only with a 5500-series form, not by itself. For those one-person plans below the $100,000 asset threshold, which do not file a 5500-EZ, how can this statute of limitations be initiated and run?

The IRS in private conversation has conceded that this is an eventuality that was not considered in setting up the rules governing the filing of 5500-series forms and Schedule P. An IRS staffer further commented that in all likelihood a Schedule P filed alone would be sent back to the submitter, and that the Service is not generally interested in those returns for which no 5500-EZ need be filed.

However, if a trustee or custodian wishes to provide for itself a measure of protection that would otherwise be given by the statute of limitations, a suggested approach is this:

1) Provide a Schedule P to all plan holders, and keep a copy in each customer's file.

2) For the IRS, provide copies of Schedule P for every one-participant trust plan regardless of whether that plan has assets of $100,000 and is likely to file a Form 5500-EZ, with a letter stating this fact, and stating that the institution is doing so to receive for all its plans the same statute of limitation protection afforded to trustees whose customers will file a Form 5500-EZ.

Inform the IRS in this letter that copies of all Schedule Ps will be kept in the institution's files, in the event that verification of this filing date and the statute of limitation period are ever necessary. (A sample of such a letter to the IRS is available from Collin W. Fritz and Associates, Ltd.) PD

1099Rs—*Continued from page 3*

fied plan. He wishes the maximum amount to be directly rolled over into an IRA. He also has a required minimum distribution due of $850. How should the assets be handled or moved and reported?

The correct approach is to:

1) Directly roll over $49,150 to an IRA at a financial institution (ABC Bank as IRA custodian for Dow Jones' IRA), and for the QP plan to generate a 1099-R form, inputting reason code G, the code for a direct rollover, and

2) Distribute $850 to Mr. Jones, and generate a second form 1099-R, inputting reason code 7 in box 7, the code for a normal distribution.

Directly rolling over the entire amount to an IRA is not the correct approach, as any RMD amount is not eligible to be rolled over. PD