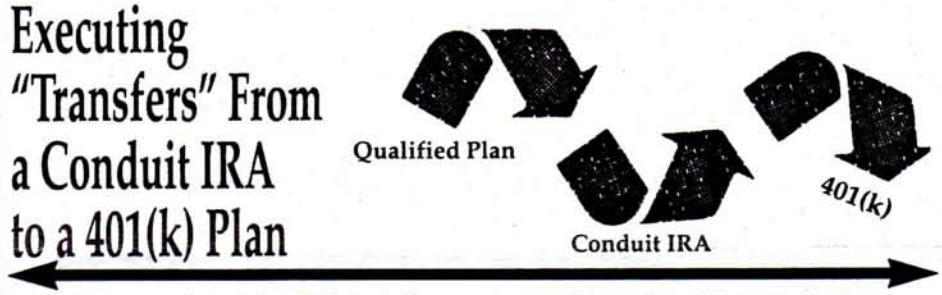
THE Pension Digest

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

Executing "Transfers" From a Conduit IRA to a 401(k) Plan



The concept of a conduit IRA is well established. When a person terminates his or her employment, most such employees who are pension participants choose to roll over or directly roll over their account balances to what may prove to be a temporary IRA (a conduit IRA), so they will not have to pay current income taxes.

This person most often will go back to work for a new employer. Or, this person may go back to work for the same employer. Many 401(k) plans are written to accept rollovers from another qualified plan, or from a conduit IRA. This provision to accept rollovers is not all that common among qualified plans other than 401(k)s, although there is no good reason why profit sharing and money purchase plans often do not allow for such rollovers.

The purpose of this article is to discuss the administrative procedures your institution should use when you receive a request from a customer or from their 401(k) plan administrator that they want the funds in the conduit IRA "transferred" to their 401(k) plan.

Simply put, the law does not authorize "transfers" between an IRA account and a QP plan, including a 401(k) plan. A transfer is a transaction that requires no governmental reporting. To have a transfer requires that the funds move between like plans (QP-to-QP or IRA-to-IRA).

Since January 1, 1993 we can move funds via a "direct rollover" from a QP plan to an IRA account. A direct rollover is defined as the movement of funds directly from a QP to an IRA or another qualifying QP plan at the instruction of the QP participant. A direct rollover looks very much like a transfer. The check is made payable to "ABC bank as IRA custodian for John Smith." However, the QP plan must report the distribution on a Form 1099-R. The IRA custodian must report the receipt of the contribution as a rollover in box 2 of the Form 5498. But this only applies to getting the funds **from** the QP **to** the IRA.

(At this time there is no law which requires an IRA custodian to remit the funds to a qualified plan at the instruction of the IRA accountholder. We will not discuss here whether there should be such a rule. The point is, there is not presently such a rule.)

IRA-to-QP Procedures

We would recommend that the IRA custodian adopt one of the following two approaches for its IRA-to-QP procedures.

Be aware that what your IRA accountholder wishes to accomplish is a rollover from an IRA to a QP plan.

Such a rollover is permissible only if there is compliance with the following rules found in Internal Revenue Code section 408(d)(A)(ii). First, the funds in the IRA must have originally come via rollover contribution from a section 401(a) QP plan or a section 403(a) annuity plan. Second, the funds withdrawn from the IRA must be re-contributed to the new QP plan within 60 days from the date of receipt from the IRA. Third, there must be compliance with the one rollover per 12-month rule. Fourth, the entire amount received from the IRA must be re-contributed as a rollover contribution to the new QP plan.

The funds must have been kept segregated from any regular IRA funds (i.e. the concept of non-commingled assets. This means a separate IRA plan agreement.).

The fact that there is a requirement to roll over the entire amount received from the IRA does not mean that the entire amount which was originally in the QP plan (plus earnings) needs to be withdrawn or that there could not have been a

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SEP, Keogh Contribution Qualifications Often Misunderstood

It seems to be human nature to try paying as little tax as possible, while remaining within the law. The problem is, however, that tax law is complicated, or is not always settled.

An institution which offers SEPs and one-person qualified plans (i.e. Keoghs) must be aware of the general rule that there must be a business entity in order to have a SEP or a qualified plan, or to make deductible contributions. Any contribution must be based upon personal service income from that business.

The qualifying businesses are: corporations, partnerships, some governmental entities, and sole proprietorships. A person who is a sole proprietor is considered to be both the employer and the employee for pension rules purposes. When a SEP or Keogh is established by a sole proprietor, the person does so in their "employer" role and not their employee role.

A person who is an employee of a business may not sponsor a SEP or Keogh plan for himself or herself. This includes a business which he or she owns as a corporate shareholder.

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Also in this issue –

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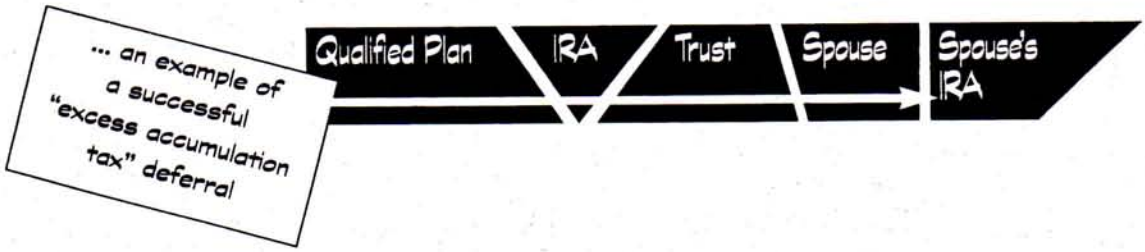
A Variation on the IRA Spouse Beneficiary "Treat-as-Own" Option



The concept of a spouse beneficiary electing to treat a decedent's IRA "as their own" is generally well understood. This typically provides the most favorable – i.e. flexible – distribution options, more so than for a non-spouse beneficiary. But occasionally there are complicating factors that make a spouse beneficiary's options less certain, and make an IRS determination valuable.

A case in point is a situation in which a spouse's deceased husband had named a trust as his IRA beneficiary (the original funding source was a qualified plan), and his spouse as the recipient of the IRA funds held in this trust.

Because of the magnitude of the accumulated IRA assets, there was also an issue of the imposition of the 15% excess accumulation tax on a decedent's estate, as specified by Code section 4980(A)(d)(1).

Several questions were raised by this situation, and put to the IRS:

1) Would these funds – once the surviving spouse had access to them via distribution from a sub-trust – be eligible to be "treated as her own" and rolled over to her own IRA, and thus not included in her income for that year for tax purposes?

2) Would timely action (an election in accordance with section 4980(A)(d)(5)) by the spouse protect the decedent's IRA assets from being subject to the 15% excess accumulations tax that can be imposed on an IRA with an account balance exceeding the threshold level?

3) Assuming timely elections were made, would the liability for the 15% excess accumulations tax be transferred from the deceased accountholder's estate to that of the surviving spouse?

More Case Facts/IRS Letter Ruling 9350040

Although preceded by the legend "This ... may not be used or cited as precedent," the IRS' comments in Letter Ruling 9350040 shed considerable light on how such trust/beneficiary and excess accumulation taxation questions might be viewed in other, similar cases.

As part of the conditions of the trust established by the deceased accountholder, the trustee was to place in a subtrust an amount that would produce the least possible federal estate tax liability. This was actually accomplished by having the surviving spouse elect to have the excess accumulations provisions (and accompanying 15% taxation) of section 4980A(d)(1) of the Code NOT apply to his estate, but to instead – upon her death – apply to her estate. This was accomplished by making a timely election in accordance with section 4980(A)(d)(5) on Schedule S of IRS Form 706, "United States Estate (and Generation-Skipping Transfer) Tax Return."

(This is only possible when a spouse is the beneficiary of essentially ALL of the decedent's interests in any qualified employer retirement plans or IRAs. If this interest is divided among multiple beneficiaries, then this deferral of the 15% excess accumulation taxation is not possible.)

The trust conditions further stipulated that the surviving spouse "shall have the right ... to withdraw ... all or any part of the principal of (the subtrust) ... upon written direction to the trustee."

The IRS advised the authorized representative of the surviving spouse in the following manner:

1) Could the IRA assets be treated "as her own"?

The decedent's IRA assets could be treated as her own by the spouse, even though they had come under her control indirectly, through the decedent's trust and a subsequent subtrust. (The IRA's true beneficiary was the trust, and she the trust's beneficiary. Not all trusts would have allowed this, but in this case it was possible.)

The IRS qualified this statement by adding that the IRA must have satisfied the section 408(a) (IRA) rules at the time they were contributed, that the assets would be rolled over into her own IRA within 60 days of her having received the distribution, and that she had not received any amounts from the (this) IRA "during the one-year period described in section 408(d)(3)(B).

(Also, any required minimum distribution (RMDs) are not eligible for rollover; 1991 and 1992 RMDs had already been distributed from the trust to the subtrust at the time this ruling request was made to the IRS.)

2) Can the IRA assets be exempted from the 15% excess accumulation tax on the deceased's estate?

The IRS held that – assuming the spouse beneficiary had properly made her Schedule S/Form 706 election (section 4980(A)(d)(5)) – the 15% excess accumulation tax would not be applied to the decedent's IRA.

3) Will the spouse beneficiary's interest in her deceased husband's IRA consequently be subject to the 15% excess accumulation tax on HER estate?

The IRS position with respect to this question was affirmative. Again, assuming that the section 4980(A)(d)(5) election was properly made by the spouse beneficiary, "the Code will apply to Taxpayer A's (spouse's) interest in his IRA as if the interest were her own interest." That is, upon her death, her estate would be taxed in accordance with the section 4980(A)(d)(1) rules pertaining to excess accumulations, if an excess accumulation exists at that time.

It should be noted that this deferral of excess accumulation liability is a one-time event. A subsequent beneficiary of this spouse beneficiary would not have this deferral option, even if she were to remarry and a later beneficiary were to be a spouse. PD

Can States Tax Nonresident Pension Distributions?

We have in the past reported on the efforts of some states to tax retirement plan distributions of non-residents. Unlike the unlimited reach and unquestioned authority of the federal government to tax these distributions, the situation is very different at the state level.

Income earned in a particular state is obviously taxable in that state in the current tax year. But how about retirement plan distributions? When tax-deferred assets earned in one state are transferred to another state by a retiree, do these assets escape the taxation reach of the state in which they were earned?

The logic of a state's right to tax is hard to argue against. Services in many states are funded in large part by state income tax revenues. Therefore, income must be accessible for taxation. By deferring taxation throughout the working years, then moving it and consequently escaping taxation, there is the potential for an imbalance in state taxation vs. state government expenditures. States that gain residents through retirement – such as the sunbelt states – may thereby gain contributions to their tax base from income that was earned beyond their borders. Other states that are net "losers" of retirees, may by this process lose revenues.

When you add the phenomenon of dual or seasonal residency – living in two or more states for different periods of the year – you have a situation in which the same individual may continue receiving state services without paying income tax in that state on their post-retirement "income" distributed from an employer pension plan or IRA.

Iowa Briefly Tests Concept

The state of Iowa is an example of a state that has wrestled with this issue. Its Department of Revenue – which has the authority to write taxation and other revenue rules within the limitations of existing Iowa law – proposed and defended the state's right to tax pension distributions of nonresidents, on income earned in the state of Iowa.

All such rules, however, must be approved by Iowa's Legislative Rules Committee. Attempts to gain this approval failed, and an effort was mounted to propose and pass legislation to clarify the state's position on this issue.

While the Department of Revenue and some legislators favored such taxation, business and industry groups opposed it, and many retained the assistance of law firms to influence the outcome. They argued that such a practice would drive jobs out of the state to neighboring states that did not have such laws.

The issue was recently decided when Iowa Governor Terry Branstad signed legislation clarifying the state position as exempting from taxation any pension plan distributions to nonresidents. This law applies to tax years beginning on or after January 1, 1994.

The effect of this law is to release all claims of the state of Iowa to income that was tax-deferred when earned within that state, and later moved to another state prior to distribution.

Other Developments

Meanwhile, recent action at the federal level would – if approved – attempt at least in part to remove such pension distribution taxation as a state option. This action came in the form of a Senate amendment to the Bankruptcy Amendments Bill of 1994, as part of legislation that has not as yet (June, 1994) become law.

If enacted, the general terms of the amendment declare that "No state may impose an income tax ... on the qualified pension income of any individual who is not a resident ... of such state." It would be effective for tax years beginning after the date of enactment.

Some Additional Provisions:

- This prohibition applies to annual distributions up to $25,000. Amounts above this threshold **may** be taxed. However, this threshold will be indexed, to rise with the cost of living in future years.
- Plans covered under this legislation include traditional qualified plans, SEPs, IRAs, annuities, eligible deferred compensation plans, and section 414 government plans (other than those maintained by states or their agencies or political subdivisions).

While it would make sense to have uniform state-to-state rules covering taxation of pension distributions to nonresidents, it remains to be seen whether this legislation would pass constitutional muster. Where is the authority for the federal government to determine what and how the states may tax income earned within their borders? If passed, this is one law that stands a good chance of being challenged, and potentially resolved before the U.S. Supreme Court. PD

Avoid Penalties on RMDs —Obtain Customer's Correct Date-of-Birth

Once an IRA accountholder reaches age 70 1/2, they must begin taking their Required Minimum Distributions (RMDs). With the help of the accountholder's tax or legal advisor, and based on IRS methods of calculation and life expectancy tables, the accountholder provides the custodian/trustee with the necessary information for these distributions.

Most custodian/trustees notify the accountholder well in advance of when they will be turning 70-1/2 so they are aware of the necessity of taking this distribution, as well as having sufficient time to obtain the advice they need. This notification is no doubt "flagged" in the institution's database by the date of birth on record for each accountholder.

If the date-of-birth is wrong and shows the accountholder as older than they are, the only consequence is either an initial distribution before it is required, or larger distributions than required if the error is not corrected.

The real concern is an error showing the accountholder as being younger than they are. This may result in not taking the initial distribution when it must be taken, and taking insufficient subsequent distributions.

Consequences to the Accountholder

A 50% excise tax can be assessed to the accountholder by the IRS for not taking the RMD on time. For example, if the accountholder had $130,000 in their account when reaching age 70 1/2 and should have withdrawn $1,600 by their withdrawal deadline, the 50% excise tax for failing to do so would be $800.

Consequences to the Custodian/Trustee

Since an accountholder may argue that the custodian/trustee had some duty to assist in making sure these distributions were made on time, it is in the custodian/trustee's best interest to make sure that the accountholder is properly notified.

Possible Safeguards

We also feel it is in the custodian/trustee's best interest to receive verification of each accountholder's date of birth, even if you have a date-of-birth listed for that individual. This can be done by writing the accountholder and requesting a reply. Or, CWF has prepared a response card that can be mailed to each of your accountholders. One version of the card asks them to verify the information you have listed. The other version asks them to complete the requested information. The back side of the card is left blank so it can be labeled and used as a self-mailer.

It is up to the custodian/trustee to determine if this request should go to all accountholders, or to those within a certain age range (based on when your records show them turning 70 1/2).

In all likelihood the information they return will be correct. If not, you have a record for your files that you requested this information; and what they stated their date of birth to be. PD

Conduit IRA—*Continued from page 1*

previous distribution from this "conduit" IRA. What it does mean is that the entire amount which is withdrawn must be recontributed to a QP plan as a rollover if any portion is to qualify for rollover treatment (tax deferral). Note that this requirement (accountholder must roll over all of the distribution) does not exist for an IRA to IRA rollover which permits a recipient to keep a portion and roll over a portion of any distribution.

When these funds are rolled over, keep in mind also that the QP administrator must segregate them from any new plan contributions. They are already vested, and as such are the property of the participant. They cannot be in any way subject – or potentially subject – to additional vesting requirements on new qualified plan contributions.

Procedural Options

1) The accountholder should sign an IRA distribution form and instruct that the check be made payable to him or her. They should waive withholding. The reason code will be a (1) for a premature/pre-59 1/2 distribution or a (7) if the accountholder has attained age 59 1/2.

Making the check payable to the person is the most conservative approach.

The accountholder can then endorse that check to the QP plan or write a personal check to the QP plan.

Your institution will prepare a Form 1099-R. Again, you will use the reason Code 1 or 7 and NOT the G or H codes which apply only to direct rollovers <u>from</u> QP plans, not <u>to</u> QP plans.

In the spirit of customer service, you may wish to inform your IRA accountholder how he or she should handle this transaction on their federal income tax return. Line 16a of the Form 1040 asks for the gross amount of the IRA distributions. Thus, the distributed amount would be listed. Line 16b asks for the taxable amount. The person would input 0 because he or she (presumably) rolled over the funds within the 60 days to a qualifying QP plan. The customer may wish to attach a note to his or her tax return, because a QP plan does not prepare any form on an individual basis informing the IRS that this person made a rollover. The QP plan does not prepare a form similar to the Form 5498 as prepared by an IRA custodian when it receives a direct rollover.

2) To accommodate the IRA accountholder/customer, the other approach would be for the IRA custodian to make the check payable to, and send to, the QP plan. But the IRA custodian must – via an accompanying letter – inform both the QP plan administrator/trustee and the IRA accountholder that this is not a true "transfer," and that it will prepare the Form 1099-R, as discussed above. The IRA custodian must still have the IRA accountholder sign an IRA distribution form and make the withholding instruction. PD

Last Call for CWF Pension Conference!

(See Pension Digest "Extra" for details.)

SEP/Keogh Contributions—*Continued from page 1*

The determination of whether or not a person's activities constitute a business is the responsibility of your customer, and not your financial institution. But it doesn't hurt to have an awareness of the rules so that you can assist them and prevent contributions being made by customers who are obviously not qualified.

Be aware that the following situations offer a good possibility that SEP or Keogh contributions would not be permissible.

Situation #1 – the owner of one or more businesses wants a plan just for herself for her role as a director of the corporation or corporations, and not for her role as president of the two corporations. In almost all situations this will be impermissible. (See the discussion which follows.)

Situation #2 – a salesperson wants to establish a SEP or Keogh. This is permissible only if the salesperson is an independent contractor (pays his own self-employment tax). He or she cannot be an employee (i.e. the employer pays the social security tax).

Situation #3 – a partner in a partnership wants to establish a SEP or Keogh for himself because the other partners are unwilling to do so. This is impermissible since the partnership is the business entity which must establish the plan.

In the following commentary we have summarized a recent court case dealing with situation #1.

Company President Unable to Make Deductible Keogh Contributions

The deductibility of Keogh contributions by a self-employed person is a significant tax benefit to those who qualify. But the distinction between being a self-employed "private contractor" and being an employee – a distinction on which this tax benefit hinges – may not always be clear-cut. Some of these distinctions were made clearer in a December 1993 United States Tax Court decision, as described below.

An individual was president, a director and sole shareholder of two corporations. He rendered services exclusively for these two corporations, plus a third, related corporation. He attempted to make a Keogh contribution as a self-employed person, which was disallowed by the IRS.

The case went to U.S. Tax Court, where the individual had to prove himself to be an independent contractor rather than an employee in order to win his case. In court he contended that all of his services and the compensation for them were under his control, therefore he was a self-employed independent contractor, and thus eligible to make tax-deductible Keogh contributions.

The Tax Court, however, sustained the IRS' finding, judging this individual to be a "common law employee" rather than self-employed, for the following reasons:

1) This individual had a permanent relationship to the corporations.

2) He performed no services for "the public or any unrelated corporation."

3) He had not made substantial investment in his own equipment to perform his services for the corporations.

In addition, he was also found to be an employee under Code section 3121(d) because his compensation was for the management services he performed as president of the corporations, rather than for the services he provided as a director of the corporations. Thus he failed another of the employee vs. self-employed tests.

Finally, the Tax Court upheld the IRS contention that additional taxes were owed by the individual because of negligence under Code section 6653, and for substantially understating his income under Code section 6661 because he could not meet his burden of proving that the IRS' determinations were incorrect. PD

THE Pension Digest EXTRA

A supplement to your monthly pension newsletter

New Annuity/Retirement CD Product Approved by OCC

The Office of the Comptroller of the Currency has recently issued its approval for banks and S&Ls to offer a new financial product, one that has become known as the annuity-CD, tax-deferred CD, or – as it is officially called by its creators – the "retirement CD." Although the IRS has not officially commented on it as of June 1, it is believed that it will qualify for tax-deferred interest, since under the tax law it will be found to be an annuity. The FDIC has already indicated that it will qualify for FDIC insurance coverage.

The test case in which OCC issued its "no objection" letter to the proposed sale of this CD involved the Blackfeet National Bank, a small bank on a Blackfoot Indian reservation in Montana.

The product was designed by Colorado-based American Deposit Corporation and has the characteristics of both a CD and an annuity. The owner receives interest at a set rate for the first one to five years, with future rates fluctuating based on the issuing institution's cost of funds, but never falling below 3%. When the CD has matured, the customer is said to be able to withdraw up to two-thirds of the principal and interest, with the remainder being distributed as periodic payments for the remainder of the accountholder's life.

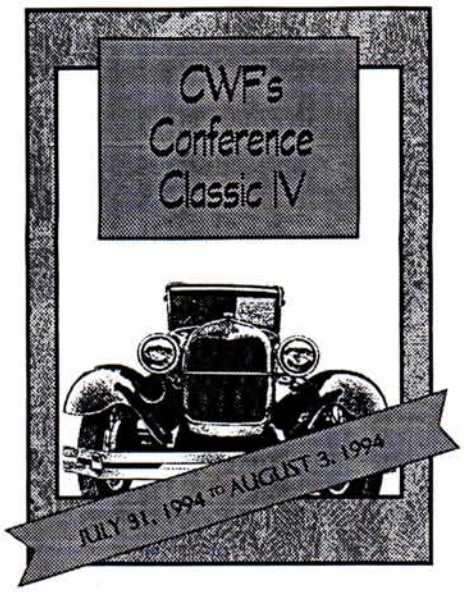
While some in the banking industry feel that the risks may be too high and potential profits too low, others believe that this innovative product has significant potential to help financial institutions regain some of the market share they have lost to insurance companies, the traditional source for annuities, and which have marketed annuities very successfully.

Some estimates place the loss in consumer CDs by banks at more than $750 million since 1990, including losses not only to annuities but also to stocks, bonds and mutual funds.

The offering of retirement annuities is not without risk to financial institutions, however. Unlike traditional CDs which pay out only what the depositor has paid in, plus interest, a retirement annuity/CD will pay out for the life of the depositor. In some cases the institution may pay out less than was deposited if the accountholder dies before their life expectancy, calculated per actuarial tables. But in other cases it may pay out more if that individual outlives their actuarial life expectancy.

One group that is not responding positively to this development, and understandably so, is the insurance industry, which faces added competition from this product. A spokesman for the American Council of Life Insurance called the prospect of banks underwriting annuities "highly improper," and some expect legislative and/or court challenges. But others, including the Comptroller's chief counsel Wm. P. Bowden, Jr., describe this financial product as "... a logical outgrowth of the bank's business mandate ... to offer its customers competitive and innovative financial products."

Whether or not this financial product will become widely accepted, or will have an impact on IRA deposits, remains to be seen. But unlike IRAs, the retirement annuity does not offer the advantage of a tax-deferred contribution, only tax-deferred earnings. If it will erode any segment of the IRA market, it may be among those (active participants with high incomes) who are currently choosing to make nondeductible IRA contributions. PD



Last Call for CWF Pension Conference

The weeks are slipping by, and the Conference Classic IV starting date July 31 is fast approaching. Don't miss the opportunity for intensive training in IRA and qualified plan subjects, taught by some of the most respected specialists in the industry. The networking and sharing opportunities are great, too. (And don't forget the great golf, tennis, fishing and water recreation for your leisure time hours.)

New Lodging Options —

Lodging flexibility has never been greater. In addition to the standard full American plan that includes all meals and recreation, you may also choose the lodging-only plan, and purchase meals and recreation as you choose.

The Conference Classic IV agenda includes:

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IRA Compliance Recordkeeping & Reporting

IRA Basics (1/2-day Program)

70 1/2 Distributions In-Depth

IRA Forms Forum

IRA Beneficiary Options

Excess & Current-Year Contributions Workshop

SEPs — General Rules, New Limitations

70 1/2 Distribution Software – In Theory & Practice

IRA Rollovers, Direct Rollovers & Transfers – Including Employer Securities

Pension Legal Review ... Divorce, Guardianship, Escheat, Beneficiaries, etc.

Electronic Forms Platform Systems – Update & Demonstration

Platform System Training

Age-Weighted Profit Sharing Plans

401(k) Overview and Design for Special Employer Needs

Qualified Plan Basics (1/2-day Program)

QPs – Deeper Issues: Loans, CAPs, Prohibited Transactions, Controlled-Group Issues, etc.

QP Forms Forum

For further information on any aspect of Conference Classic IV, call us at 1-800-346-3961.