



# THE Pension Digest

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## Required Distribution Reminder and MDIB Pitfalls

The deadline for taking required minimum distributions for accountholders who are over age 70 1/2 is fast approaching. The deadline for 1994 distributions, for accountholders who attained age 70 1/2 prior to 1994 is December 31, 1994. By this date the accountholder either needs to take a distribution from each IRA or must certify to the appropriate IRA custodian/trustee that they have taken the distribution from another IRA account. This certification should be obtained in writing. It can be done on CWF's Form #312.

A problem area we have encountered occurs with the application of the MDIB rules. We will go through a general discussion of the rules and point out areas where mistakes are often made.

An IRA accountholder must make his 70 1/2 elections by April 1 of the year after the year he attains age 70 1/2. These elections are necessary even where it appears MDIB will be used. Why is this? The rule set forth in the proposed regulation requires a comparison of the Required Minimum Distribution (RMD) amount calculated using the general method to the RMD amount calculated using the MDIB method. Whichever method gives the largest distribution amount is the method which must be used for that year.

Another general rule for required distributions is that when there is more than one beneficiary, the oldest beneficiary is used to obtain the correct life-expectancy factor. The rules also state that when there are nonspouse beneficiaries, the distribution must satisfy the Minimum Distribution Incidental Benefit (MDIB) rules. The MDIB rules contain a special life-expectancy table that provides the factors used for calculating many distributions when there are nonspouse beneficiaries. The factors contained in the MDIB table are the same as the factors found in the regular joint life-expectancy table, using ages 10 years apart. For example, the MDIB factor for age 70 is 26.2. If you were to look at the regular joint life-expectancy table for ages 70 and 60, you would get the same factor of 26.2. Because of this it is often said that when there is a nonspouse beneficiary who is 10 years or more younger than the accountholder, MDIB is automatically used. This is not the case. The rule set forth in the proposed regulation really requires that a comparison be made. The factor from the regular joint life-expectancy tables, based on the accountholder's 70 1/2 elections, is to be compared to the MDIB factor. The smaller of the two factors is what is used. An example of how this works is shown here.

John is 70 1/2 and 70 in 1994. He has elected a joint life expectancy and one-year reduction of his life-expectancy factor. His beneficiary is his sister Susan who is 58. What will be the factors that are used? The rule requires a comparison of the regular factors to the MDIB factors. They are shown in the following table.

Year	Regular Factor	MDIB Factor	Factor to Use
1994	27.6	26.2	26.2
1995	26.6	25.3	25.3
1996	25.6	24.4	24.4
1997	24.6	23.5	23.5
1998	23.6	22.7	22.7
1999	22.6	21.8	21.8
2000	21.6	20.9	20.9
2001	20.6	20.1	20.1
2002	19.6	19.2	19.2
2003	18.6	18.4	18.4
2004	17.6	17.6	17.6
2005	16.6	16.8	16.6

As illustrated in this example, the regular life-expectancy factor can "catch up" to and become smaller than the MDIB factor. When that occurs, in this case in 2005, the 70 1/2

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## Notes on 401(k) Plan Trends

Two recent 401(k) surveys reveal some trends in these popular retirement plans. The surveys were conducted by Buck Consultants, Inc. of New Jersey, and Godwins, Booke and Dickenson (GBD) of Florida.

### Employee Investment Options Important, Expanding

- Buck's survey of 401(k) plans revealed that nearly 85% of plan sponsors offer participants at least four investment options. The average number of options was slightly more than five. Of those plans contemplating investment option changes, three-fourths expect to offer more investment choices in the future.

- Company stock and derivative funds account for one-third of the assets in the 401(k) plans surveyed. The order in which the average participant invested in various fund types was found to be: 1) stable value funds, 2) index stock funds, 3) balanced funds, and 4) growth stock funds.

- The vast majority – more than 80% – of 401(k) plans allow participant loans. And among those plans not currently containing a loan provision, nearly half are considering the addition of such a provision.

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distribution amount is calculated using the regular life factor. While it may take awhile for the regular factor to become smaller than MDIB, it is critical that the comparison be made or an accountholder may not take a large enough distribution. Each situation is different. Always make the comparison.

A second situation with MDIB that arises is that the MDIB table doesn't get used when it should. The situation we see occurring happens when there is a spouse beneficiary and additional nonspouse beneficiaries to an IRA. The rules say MDIB requirements must be met anytime there is a nonspouse beneficiary to the IRA. Many times what occurs is that when the spouse beneficiary is the oldest beneficiary, the custodian/trustee of the IRA assumes that MDIB will not apply since the oldest beneficiary is a spouse and the MDIB rules apply to nonspouse beneficiaries. This is not always the case. As previously stated, MDIB applies whenever there are nonspouse beneficiaries. Again, the comparison discussed previously is required to insure that the 70 1/2 distribution rules are complied with. An example again is needed to illustrate this situation.

Bill is 70 and 70 1/2 in 1994. He has two IRA beneficiaries. They are his wife Mary, age 58, and his son Mark who is 35. He has elected a joint life expectancy, recalculation of the factor. What will the life expectancy factor be? Again we make a comparison using the regular life factor for the oldest beneficiary and the MDIB factor.

Year	Regular Factor	MDIB	Factor To Use
1994	27.6	26.2	26.2
1995	26.7	25.3	25.3
1996	25.8	24.4	24.4

As can be seen, MDIB gives the smaller factor and as such, the factor we must use. However, this could be avoided. If the accountholder separated their IRA in such a manner so that each beneficiary were to be beneficiary of a separate investment instrument, we would use the regular factor for the spouse's portion of the IRA and the MDIB factor for the nonspouse's portion of the IRA. While this would result in more work for the IRA custodian/trustee, it would reduce the accountholder's required distribution.

Based on the two previous situations, it is apparent that the 70 1/2 election (recalculation versus nonrecalculation) is still

necessary, even where it appears the MDIB tables will be used. It becomes even more apparent when we look at beneficiary distribution situations. The rules require that a beneficiary must continue or accelerate the schedule established by the accountholder when the accountholder dies after the required beginning date. The following situation illustrates again the MDIB vs. regular factor comparison for an accountholder. It then goes a step further and shows what will happen when the accountholder dies.

Dave Thomas attains age 70 and 70 1/2 in 1994. His designated beneficiary is his daughter, Priscilla Dean, age 48. He asks, "since the MDIB rule will apply, do I even need to make my RMD election? If I do, what difference does it make whether I elect recalculation or nonrecalculation?"

An IRA accountholder must still make his RMD election even though the MDIB life expectancy table will be used to furnish the life expectancy factor for the RMD calculation. Keep in mind that the proposed regulation governing RMD calculations actually requires two calculations when the designed beneficiary is more than 10 years younger than the IRA accountholder. First, one must perform the "regular" RMD calculation using a joint or single life-expectancy factor as applicable. Second, one must perform the MDIB calculation. The IRA accountholder must use whichever method requires him or her to withdraw the largest amount. Normally, this will be the MDIB method. Because the account balance to be used will be the same under both methods, the factor which will differ is the life-expectancy factor.

A comparison is set forth below. Note that there are two regular methods — regular

method #1 shows the factor when Mr. Thomas elects to recalculate his life-expectancy factor. Regular method #2 shows the factor when Mr. Thomas elects to not recalculate his life-expectancy factor (i.e. uses one-year reduction).

It also assumes that Mr. Thomas will die in 1998. The rule is that the beneficiary must continue (or speed up) the schedule which the accountholder had established. Note that the schedule to be continued is the "regular" schedule, because the MDIB schedule/rule only applies while the accountholder is alive.

Also, note that there is little difference in this situation in the factor to be used after the accountholder dies regardless of whether the accountholder elected to recalculate or not recalculate his life expectancy.

The beneficiary, Priscilla Dean, must continue the "regular" schedule which he elected. It would either be the recalculation schedule or the one-year reduction schedule. Since he has died, the recalculation schedule is changed by his death. To determine the factor for the following year (1999), determine Priscilla's life expectancy factor as of 1994 based upon her age in 1994. Since she is 48 this factor is 34.9 but it needs to be reduced by five since five years have passed since 1994. The one-year reduction rule applies now since as a nonspouse she must use the nonrecalculation method. These schedules are set forth below.

From this discussion, it is obvious that 70 1/2 elections are always necessary even where it is obvious that the MDIB table will apply. It is also apparent that a comparison of MDIB to the regular factors should be done every year when the accountholder has nonspouse beneficiaries. **PD**

### Comparison of Calculation Methods

Year	Regular Method #1	Regular Method #2	MDIB	Factor To Use
	LE Factor (Recalculation)	LE Factor (One-Year Reduction)	LE Factor	
1994	35.7 (use 6 step)	35.7	26.2	26.2
1995	33.9	34.7	25.3	25.3
1996	32.9	33.7	24.4	24.4
1997	32.0	32.7	23.5	23.5
1998	31.1 (he dies)	31.7	22.7	22.7
1999	29.9	30.7	N/A	N/A
2000	28.9	29.7	N/A	N/A
2001	27.9	28.7	N/A	N/A

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#### Employees Bearing More Of Contribution Responsibility

Florida-based GBD's survey was more regionally-based, but also revealed some interesting trends that may hold true throughout the rest of the country as well.

- The number of GBD-surveyed plans that are funded solely by employee participants — salary reduction-only plans — grew in proportion to the total number of 401(k) plans. Roughly 20% of survey respondents sponsor this type of plan. When last surveyed, the figure was 12%.

This corresponds with a decrease in plans

that provide employer matching or profit sharing contributions, or both. The current survey shows that 76% of plans have such employer contribution provisions, down from 88% in 1992.

The upshot is that employees in many companies are shouldering more of the contribution responsibility, and the employer less. **PD**



# House Passes Bill That Would Modify Bankruptcy Amendments Bill of 1994 ... would further limit source taxation of pension distributions

The hotly contested issue of source taxation of nonresident pension distributions continues. The latest chapter is House passage of HR 546, passed October 3, that would place further limitations on states' ability to enact and enforce such source taxes. The effect of this legislation would be to protect the first \$30,000 of qualified nonresident pension income from source taxation. No similar legislation has yet been passed in the Senate.

This legislation is aimed at modifying the Bankruptcy Amendments Bill of 1994 (passed in April, 1994) which placed some restrictions on a state's ability to tax pension distributions to former residents. Under that Bill, distributions that are part of a series of substantially equal periodic payments over a period of 10 or more years are exempt from such source taxation. Certain recipients may also be exempted from the taxation of the first \$25,000 of retirement plan distributions for that year. Other distributions, however, whether partial or total, are taxable under this as-yet-untested law. This includes post-70 1/2 distributions, which are not "substantially equal" because they're based on life-expectancy and account-balance factors.

But if Congress enacts and the President should sign legislation similar to HR 546, the first \$30,000 of either total, partial or 70 1/2 distributions would be exempt.

The Profit Sharing Council of America (PSCA) has been actively urging Congress to rewrite the bill's provisions to exclude all distributions from any source tax on distributions to former residents. Specifically targeted have been the House Ways and Means Committee and the Senate Finance Committee, who have been warned by PSCA that the result of not doing so will be extreme administrative difficulties, and the prospect of double taxation for employees.

## Potential For Double Taxation Cited

PSCA asserts that to avoid multiple taxation, a pension plan

participant would have to substantiate the portion of their distributed benefits that can be allocated to each state in which they have worked. Currently, says PSCA, no one keeps such records, making verification very difficult.

PSCA anticipates potential congressional counterarguments might include the creation of an allocation or apportionment formula for plan participants who have worked in several states. The Council asserts that it would not be possible to design an apportionment system that all 50 states would sanction.

## Is Taxation Possible Where \$\$\$ Still in "Retirement System"?

Under current law, lump-sum distributions are shielded from federal taxation if they are rolled over into another qualified retirement plan, or IRA. But under the Bankruptcy Amendments Bill of 1994, according to PSCA, state governments could conceivably require in-state employers to withhold taxes on all distributions, whether rolled over or not.

This, says PSCA, would set up a conflict with ERISA, the authority that provides the tax-deferral protection afforded to such lump sum distributions when properly rolled over.

## Who's Favored By Prohibition On Source Tax?

The states most favored by a no-source-tax law are those where workers retire and bring their accumulated retirement plan assets with them. This would favor the South, Southwest and West regions of the country.

States that stand to lose the most are typically northern and northeastern states, some of which experience a population loss among those who are in the retirement-age category.

We will keep you informed of any Congressional progress of a Senate companion bill to HR 546. **PD**

# Don't Forget About PTE 93-33

Many financial institutions have programs where certain programs receive services (outside of the IRA) at reduced or no cost. Such customers may include IRA customers/depositors if the rules found in PTE 93-33 are met.

Does the following program comply with the rules of PTE 93-33?

The financial institution will waive its service charge on a checking account if the customer:

1. Maintains a minimum daily balance of \$400 or more in the checking account;
2. Maintains an average daily balance of \$900 or more in the checking account;
3. Maintains a minimum daily balance of \$8,000 in a combination of one to three special deposit accounts (savings, time deposits or IRAs).

The five conditions of PTE 93-33 are set forth below:

1. The IRA or Keogh plan, the account balance of which is taken into account for

purposes of determining eligibility to receive services at reduced or no cost, is established and maintained for the exclusive benefit of the participant covered under the IRA or Keogh Plan, his or her spouse or their beneficiaries.

2. The services must be of the type that the bank itself could offer consistent with applicable federal and state banking law.

3. The services are provided by the bank (or an affiliate of the bank) in the ordinary course of the bank's business to customers who qualify for reduced or no-cost banking services but do not maintain IRAs or Keogh plans with the bank.

4. For the purpose of determining eligibility to receive services at reduced or no cost, the account balance required by the bank for the IRA or Keogh plan is equal to the lowest balance required for any other type of account which the bank includes to determine eligibility to receive reduced or no-cost services.

5. The rate of return on the IRA or Keogh

plan investment is not less favorable than the rate of return on an identical investment that could have been made at the same time at the same branch of the bank by a customer of the bank who is not eligible for (or who does not receive) reduced or no-cost services.

Although there are five conditions (each which must be met), this article discusses only requirement (4) — "the account balance required by the bank for the IRA or Keogh is equal to the lowest balance required for any other type of account which the bank includes to determine eligibility to receive reduced or no-cost services."

The program described above does not comply with this rule. The IRA balance cannot be required to be larger than the lowest balance which is allowed for any other account (including the checking account itself). Thus, the IRA balance required must be \$400 since that is the lowest balance required for any other account. And even

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though it may be more advantageous or easier for the customer to satisfy the "average daily checking account balance" requirement than the minimum daily balance requirement of \$900, Condition (4) is based upon the "balance" and not any other factor. Thus, the \$400 amount is still the only amount which could be required with respect to the IRA.

The point of this article is that any reduced cost/no-cost program which considers the balance of an IRA or Keogh must be reviewed very carefully to make sure that all five conditions of the PTE 93-33 are met.

### ***PTE 93-33 grants special relief to the following covered transactions:***

#### **Section I: Covered Transaction**

Effective May 11, 1993, the restrictions of sections 406(a)(1)(D) and 406(b) of ERISA and the sanctions resulting from the application of section 4975 of the Code, including the loss of exemption of an individual retirement account (IRA) pursuant to section 408(e)(2)(A) of the Code, by reason of section 4975(c)(1)(D), (E) and (F) of the Code, shall not apply to the receipt of services at reduced or no cost by an individual for whose benefit an IRA or, if self-employed, a Keogh Plan is established or maintained, or by members of his or her family, from a bank pursuant to an arrangement in which the account balance in the IRA or Keogh plan is taken into account for purposes of determining eligibility to receive such services, provided that each condition of this exemption is satisfied. **RD**

## **The Negligence and Substantial Tax Preparation Penalties As They May Apply to IRA/QP Distributions**

An IRA or QP custodian/trustee is required by law to prepare a Form 1099-R for the IRS and for the person being paid whenever there is a distribution from an IRA or Qualified Plan.

What happens if the IRA or QP custodian/trustee prepares the Form 1099-R, but the individual fails to insert or include the distribution amount on his or her tax return?

The tax court in a recent case adopted the IRS' argument that the taxpayer should pay the special 20% additional penalty tax as authorized by Code section 6662 which applies when the taxpayer has committed negligence in the preparation of the return and/or has substantially understated the amount of income tax due. The tax court case was *Dorothy L. and Ralph Stoetzel v. Commissioner*, United States Tax Court, T.C. Memo 1997-174, April 19, 1994.

Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Tax Code.

In general, there is a substantial understatement of income tax due for the taxable year if the amount of the understatement exceeds the greater of (1) 10% of the tax required to be shown on the return for that year or (2) \$5,000.

As an example, let's assume that Pat Rinke, an IRA accountholder, age 54, withdraws \$4,600 from her IRA. The IRA custodian prepares a Form 1099-R with a reason code (1) and furnishes it to her. Pat fails to include this \$4,600 on her income tax return. Thus, she does not pay income tax (at a rate of 15%, 28%, 31%, etc.) and she does not pay the 10% excise tax which applies since she was not age 59 1/2 and no other exception applied.

Because the IRA or QP custodian/trustee prepared the Form 1099-R, the IRS will most likely contact her and ask her why she didn't include the \$4,600 in her income and pay taxes on this amount. If she doesn't have a good explanation, the IRS will most likely assess the 20% penalty for negligence.

The additional tax for a substantial underpayment will not apply since that tax only applies if the amount of the understatement is at least \$5,000 of additional taxes. Note, however, that in the right circumstances the IRS may assess the 20% for negligence, and the 20% for a substantial understatement. **RD**

## **✓✓ Check It Out ✓✓**

**Question:** Our bank just purchased a distressed bank which was in FDIC receivership. We have assumed responsibility for that institution's IRAs. One of the IRA account holders is one Maria Parrott, who had an IRA with four time deposits totalling \$138,000. The FDIC has informed her and us that she is going to lose the \$38,000 (i.e. the amount in excess of the \$100,000 insured amount). Does our bank need to prepare a Form 1099-R to report the payment of this \$38,000? If so, is the payee Maria Parrott or the FDIC?

✓ **Answer:** Your bank definitely should not prepare a Form 1099-R in the name of Maria Parrott. She was never paid these funds. Conceptually, she has suffered an investment loss similar to investment losses suffered by many self-directed IRAs. Investment losses are not reported to the IRS on the Form 1099-R. The most conservative approach would be for your bank to generate a Form 1099-R in the name of the FDIC, but we do not think it would be required. The FDIC is not going to pay any taxes on this distribution.

**Question:** Would you please discuss the "tinting" which a bank or similar financial institution should use with respect to its qualified plans? There seems to be a conflict - the IRS wants the Form 1099-R used to report distributions prepared using the individual's name, social security number and address, whereas the FDIC rules require that the title reflect the special status of the account (i.e. a QP plan) if the account is to qualify for separate \$100,000 coverage.

✓ **Answer:** The practical problem of what title to use normally arises because your computer software allows you to input just one title. If the software was well written, it would be able to accomplish both of these tasks - make sure the FDIC insurance coverage is maintained, and generate the Form 1099-R correctly.

Of the two needs or goals, the FDIC goal is probably the most important and the tinting should accomplish this objective first.

The trustee of the qualified plan owns the time deposit, savings account, etc. on behalf of the plan. More specifically, the trustee owns the time deposit on behalf of the plan and one specific participant. For example, Carlos Rand as trustee owns a \$35,000 time deposit on behalf of "The Carlos Rand Profit Sharing Plan fbo Carlos Rand." If the time deposit is titled in this way, there will be separate FDIC insurance coverage for these QP funds from Mr. Rand's other personal accounts.

But what happens if Mr. Rand as a participant withdraws \$4,000?

Someone needs to prepare a Form 1099-R which indicates that Mr. Rand as an individual is the payee. Under the law, this duty technically belongs to Mr. Rand as the plan sponsor unless he takes some special steps to transfer this duty to the financial institution. Most financial institutions, however, still will prepare the Form 1099-R for customer service reasons. If so, it is preferable to show Mr. Rand as the payee.

**Summary.** It is best if your software can handle both of these QP reporting/tinting situations. If not, we would recommend that you place FDIC concern first and title the account for all reasons (including 1099-Rs) as Carlos Rand as trustee of the Carlos Rand profit sharing plan. **RD**

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