THE Pension Digest

Published Since 1984 Collin W. Fritz and Associates, Inc., *"The Pension Specialists"* June, 1995

IRA Beneficiary Designation Procedures & Pitfalls

When a person opens an IRA, one of the things they usually do is designate beneficiaries to the account. It is important that beneficiary designations be handled correctly by both the accountholder and the custodian or trustee of the IRA. A large portion of the litigation that relates to IRAs today occurs either because of the way the designation was completed or because of the procedures the custodian/trustee had in place for handling these designations. This article will focus on the basic beneficiary designation rules and procedures and will also examine some of the more unusual situations that you should watch for.

IRA Established

When the IRA is established, the accountholder generally has the right to designate both primary and contingent beneficiaries. They are, however, not required to do so. In most states, the accountholder can designate anyone they wish as their IRA beneficiaries. In some states, however, the spouse must be the named primary beneficiary unless they give written consent to allow the designation of someone other than themselves. These states are called community or marital-property states. The states that have either community or marital-property laws are California, Louisiana, Arizona, Idaho, Nevada, New Mexico, Texas, Washington, and Wisconsin. In these states, if the accountholder is married and wishes to name an IRA beneficiary that is not the spouse, the spouse must sign a written consent that permits this change. Without this consent, a designation other than the spouse would be deemed invalid in these states. Most IRA applications and beneficiary designation forms have a place on them for the spouse to sign and give this consent.

As stated, the accountholder can name primary and contingent beneficiaries. We often find confusion as to what the difference between these types of beneficiaries is when funds are distributed. Primary beneficiaries are the beneficiaries that will receive the IRA proceeds if they are living at the time the IRA accountholder dies. It is important that you check your IRA form to determine what rights a primary beneficiary has to receive the funds. Many IRA forms state that if one primary beneficiary pre-deceases the accountholder, that primary beneficiary's share will go to the surviving primary beneficiaries. An example of how this works is illustrated here. John Smith has named his three children, Mary, Joe, and Sue as his IRA beneficiaries. Each is to receive 1/3 of his IRA. His IRA plan says that if a primary beneficiary pre-deceases the accountholder, the surviving primary beneficiaries' shares will be increased on a pro rata basis. Joe died in 1994. In 1995 the accountholder, John, passed away. Mary and Sue will each receive 50% of John's IRA.

Some IRA forms, such as CWF's, allow the accountholder to elect a different type of option for the primary beneficiary designation. CWF's form allows the accountholder to choose to have a deceased primary beneficiary's share pass to the primary beneficiary's heirs and issues. Using the same example, if John had chosen this option on CWF's form, Joe's 1/3 share would have passed to his children. Mary and Sue's share would not have been increased but instead stayed at 1/3 each. This is an option many accountholders find useful. The legal term for this is per stirpes.

Contingent Beneficiary Rights

We have also encountered confusion as to when contingent beneficiaries are to receive the IRA proceeds. Contingent beneficiaries are generally named to provide for one situation, that situation being a case where all of the primary beneficiaries have died before the accountholder. Then, and only then, do contingent beneficiaries receive IRA assets. A contingent beneficiary's rights die with the accountholder if any primary beneficiary is living at that time.

One area of confusion that arises occurs when there was a primary beneficiary alive at the time of the accountholder's death, but that primary beneficiary dies before they have received all of the funds they were entitled to. What then happens to the remaining money? Many people are under the mistaken impression that the

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contingent beneficiary(ies) will receive the remaining funds. This is not the case. When the accountholder died, the primary beneficiary became the beneficial "owner" of their share of that IRA. When that primary beneficiary dies, the remaining portion of their share will generally go to their estate.

Proper Documentation

While the standard beneficiary form works for most accountholders, there may be cases where it is inappropriate. A good example of a situation like this is when you have an accountholder that is in a second marriage and had children in a previous marriage. The accountholder may wish to name their second spouse as their primary beneficiary and their children as contingents. This is fine as far as it goes.

As illustrated above, however, the potential for problems exists. What would happen under a standard beneficiary form if the accountholder dies, the second spouse started withdrawals but then died before receiving all of the funds? The second spouse's estate would receive the balance of the IRA. Remember that a contingent beneficiary's rights die with the accountholder if any primary beneficiary is alive. What the accountholder would probably prefer is that anything remaining in the IRA at the time the second spouse dies, pass to the children of the accountholder. Special language would need to be drafted to accommodate this desire. This language should be drafted only by the accountholder's own legal counsel. Anytime the accountholder is asking to have a designation made that does not seem to fit the general designation rules discussed above, these changes should be sent to their legal counsel to draft a special designation document. This document should be signed by the accountholder, witnessed and notarized. The custodian/trustee needs a copy for the accountholder's file and the accountholder should also have a copy. While it is helpful to the IRA custodian/trustee to be able to recognize situations where a standard form may not be appropriate, the actual advice and drafting of special language should be left to legal counsel.

No Named Beneficiaries

What will happen to the IRA funds if the accountholder did not designate a beneficiary? Generally the funds will be paid to the estate. It is important, however, that you check your IRA plan agreement. We have seen a few IRA plans that state if no beneficiary was named, the spouse will be the beneficiary. Check your plan agreement to see what it says or states happens when there isn't a named beneficiary.

Proper Custodian/Trustee Procedures

With IRA balances growing larger and larger each year, the potential for disputes over beneficiary designations becomes more and more prevalent. What can an IRA custodian/trustee do to help avoid these potential disputes?

(1) The first recommendation is to make sure that you have a valid beneficiary designation on file for each IRA account. Remember that a valid designation could include a signed IRA application where no beneficiary was named. If there is no beneficiary form at all in the accountholder's file, get one completed and signed as quickly as possible.

(2) When the accountholder has named beneficiaries, make sure that you have all the information asked for regarding each beneficiary.

(3) While not required, it is a good idea to remind your IRA accountholders periodically of who they have named as their beneficiaries. Accountholders often times do not seem to remember their IRA beneficiary designations when their circumstances change. Beneficiaries could pass away; the accountholder's marital status may change. Many things can occur that should result in a change of beneficiaries. By reminding the accountholders of their current designation, future problems can be avoided when the accountholder's circumstances have changed.

(4) Retain a copy of every beneficiary designation the accountholder has made. Make sure you are able to document which designation is signed and dated by the accountholder. An unsigned or undated beneficiary designation will generally be invalid.

(5) Also be careful in the completion of the document. If any information is crossed out or changed make sure this is initialed by the accountholder.

(6) One final point, you should not give advice to the accountholder as to who they should name as their beneficiary or what they should do in certain situations. This advice must be left to their own legal counsel. All you can do is explain to the accountholder that they have the right to designate beneficiaries, what each type of designation means, and what happens if they don't name beneficiaries. Anything further needs to be handled by their attorney.

By following these fairly simple and general procedures, you can help your institution and your accountholder avoid beneficiary disputes in the future. PD

5500 Filing Reminder

Most employers who sponsor a Qualified Retirement Plan are required to file a 5500 return for the plan. The 5500 return is due by the end of the seventh month after the close of the plan year. For any employer on a calendar year basis, this means the appropriate 1994, 5500 return is due by July 31, 1995. This deadline is approaching quickly.

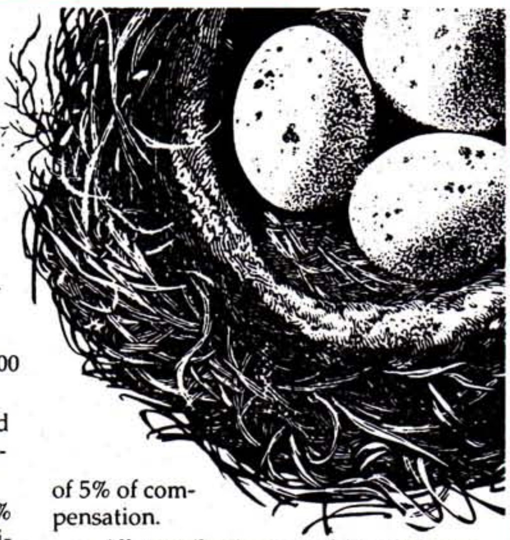
Employers who sponsor plans that have 100 or more participants at the beginning of the year are required to file the Form 5500. Employers who sponsor plans with less than 100 participants are required to file either the Form 5500-C or the Form 5500-R. The 5500-C must be the form filed in the initial plan year, i.e. the year the plan is established, every third year thereafter, and in the year the plan is terminated. The Form 5500-R may be filed in the intervening years.

A Form 5500-EZ is used by one-participant plans. A one-participant plan is a plan that covers only the employer or the employer and the employer's spouse. The 5500-EZ needs to be filed for the year the plan was established, the year it is terminated, and in any year the total assets in the plan exceed $100,000, or when the employer sponsors more than one, one-person plan and total assets in all plans sponsored by the employer exceed $100,000.

There has also been one change to the 5500-EZ filing requirements. In the past the 5500-EZ only needed to be filed upon plan establishment, termination, or if during that year the assets were over $100,000. The new instructions to this form now read that if the plan assets ever exceeded $100,000, the Form 5500-EZ needs to be filed every year thereafter. This is a new requirement that employers may not be aware of. Employers who have a one-person qualified plan should be made aware of this change.

The institution that sponsors any Qualified Plan document and/or acts as trustee of any plan should also complete the Form Schedule P. This needs to be furnished to the employer and it should be filed by the employer with their 5500 return. PD

NEST — A New Pension Plan Proposal Which Uses IRAs



On June 12, President Clinton gave a speech to the White House Conference on small business. He made clear his belief that pension simplification is an essential factor to reducing the legal and regulatory burden faced by small businesses. He supports a report to simplify pensions containing 29 high-priority actions of which 6 are considered most important. One of these six is the creation of a new type of employer-sponsored pension program called a "NEST," National Employee Savings Trust.

A brief summary of the features of the NEST are set forth. Next month's newsletter will discuss in more detail the other changes proposed by President Clinton. The NEST, like the SEP (simplified employee pension plan), would involve the use of an IRA as the funding vehicle for the pension plan.

Description: A NEST is a tax-favored retirement savings plan designed to provide small employers with a simple, cost-effective means of providing a retirement plan for their employees. It achieves these goals primarily by eliminating several complex nondiscrimination tests that apply to traditional qualified plans and, instead, simply requires an employer to make NEST contributions in accordance with one or two specified plan designs.

The key features of the NEST are:

• Any employer with 100 or fewer employees would be eligible to maintain a NEST.

• Each employee, age 21 or older, who completed two years of service with the employer would participate in the NEST. However, an employer would not be required to make nonelective contributions for an employee with less than $5,000 of compensation for the year.

• The NEST would have to be designed to satisfy one of the following two formulas:

(1) The employer contributes at least 3% of pay for each eligible employee. In addition, employees *may* be given the opportunity to make salary reduction ("or elective") contributions.

(2) The employer contributes at least 1% of pay for each eligible employee. In addition, employees *must* be given the opportunity to make elective contributions. Employee elective contributions of up to 3% of compensation must be matched by the employer dollar-for-dollar. The employer match for elective contributions above 3% of compensation (and up to 5% of compensation) must be at least 50 cents per dollar of elective contributions. No employer matching contribution is allowed for elective contributions in excess of 5% of compensation.

• All contributions would be made to an IRA and would be immediately 100% vested. However, withdrawal of any NEST contribution would be restricted for two years.

• An employer would generally be allowed to make contributions for all employees to the same financial institution. However, an employee could subsequently move the NEST funds to an IRA at another financial institution.

• NEST accounts would be portable — NESTs could originate and receive rollovers from any other IRA, and NESTs could receive rollovers from qualified plans. Pb

New 5500 Filing Program for Delinquent Filers

Over the years we have encountered a number of situations where an employer had a Qualified Plan but had not made all the required Form 5500 filings for the plan. In the past there was not much that could be done other than make the past filings and face the penalties assessed by the IRS and the Department of Labor. A new program offers some relief for anyone in this situation today.

The Department of Labor (DOL) has announced a new voluntary program that will allow Qualified Plan administrators who are late in filing or never filed the required 5500 returns for the plan to correct these deficiencies. The program is called the Delinquent Filer Voluntary Compliance (DFVC) program. Plan administrators who use this program will still face DOL penalties but they will be much less severe than the usual DOL penalties for late 5500 filings.

Eligibility for this program is limited to plan administrators who filed a 5500 return late or never filed it at all. Additionally, the plan administrator must not have received notice from the DOL of failure to file a timely 5500 return or of the DOL's intent to assess penalties for failure to file the 5500.

When a plan administrator qualifies for the DFVC program under the eligibility guidelines discussed above, late and non-filing plans can be brought into compliance. This is done by filing a completed Form 5500 or Form 5500-C for each plan year that the appropriate 5500 was not filed. A 5500-R may not be used under this program. Even if the form the plan administrator failed to file was the 5500-R, the 5500-C will have to be used under this program. The entire form needs to be completed along with all required schedules. The plan administrator is required to write in red on the first page of the form "DFVC Program." The form must be signed by the plan administrator and the plan sponsor. The completed form is then mailed to the IRS service center listed in the instructions for the 5500 forms. The plan administrator is supposed to use the 5500 return for the year the filing was not made. If, however, the plan administrator cannot locate a 5500 form for a prior year, the program instructions say that the current year's form can be used. The plan administrator is to cross out the year printed on the top of the form and enter the appropriate year in red ink. No penalty payments are sent with the 5500 filing made to the IRS. Instead, the plan administrator is instructed to send a signed and dated copy of the first page of the 5500 form to the DOL along with a check for the penalty amount. Both the check and the first page of the form must have marked in red ink "DFVC Program." The check should be sent to the following address:

DFVC Program
Pension and Welfare Benefits Administration
P.O. Box 277025
Atlanta, GA 30384-7025

For plan administrators who have already filed 5500 returns but filed them late, the DFVC program is still available as long as the plan administrator has not received any notification from the DOL as was mentioned earlier. There is no requirement to refile the form. Instead, the first page of the 5500 form is sent to the address listed above with the appropriate penalty amount. Again, the notation "DFVC Program" needs to be made on all submitted materials.

Why would an employer avail themselves of this program? As has been mentioned in these materials, this program does not alleviate all the penalties. What it

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IRA Contribution Deadline

This is the time of year when we often receive calls from IRA custodians or trustees that have an accountholder come in who wishes to make their 1994 IRA contribution. Most know that it is too late for a 1994 contribution at this time. The response from the customer is almost always the same one, "My tax advisor told me I could do this because I have an extension on my Federal income tax filing deadline." It is unfortunate that they received this advice because it is blatantly wrong.

The deadline for making an IRA contribution is the deadline for the individual's Federal income tax return. Normally this is April 15. This year the deadline was actually April 17, 1995, as the 15th fell on a Saturday. The rules for the contribution deadline are quite clear. IRA contributions end on the Federal income tax return due date, absent extensions. This means that filing an extension for a Federal income tax return does not extend the IRA contribution deadline. If a person has not yet made their 1994 IRA contribution, it is too late.

There is one exception to this basic rule. An IRA could still receive a contribution for 1994 if the contribution is a SEP contribution made by the person's employer. The employer would have to have an extension if the employer's 1994 business tax return due date in order for this to be permissible.

One other interesting side note to this discussion — it is a long-held rule that a person can file their tax return and claim an IRA deduction on the return prior to making the actual contribution to the IRA, as long as the contribution is made by April 15, the Federal income tax return deadline. Many people do this, especially those who will be receiving a tax refund. The reason for this is that many of these individuals use the refund as the source of dollars for their IRA contribution. This may have been a dangerous practice this year. The IRS, as many of you may be aware, has been very late in sending out refunds in some cases. It has been reported that the IRS sent out $8.8 billion dollars in personal income tax refunds on the last Friday in May. This is a significant portion of the refunds that were sent out this year. If anyone had claimed a deduction for an IRA contribution on their tax return, was waiting for their refund to get the money necessary to make the contribution, and didn't receive it until after April 17, they have a problem. Regardless of whether or not they claimed a deduction on their tax return, a contribution cannot be made at this time. Anyone in this situation will have to file an amended tax return and remove the deduction for an IRA contribution. This will definitely cause that person some tax problems. Hopefully none of you have customers in this situation. PD

5500 Filing Program—*Continued from page 3*

does do, however, is greatly reduce the penalties a plan administrator faces for filing late or failing to file. The DOL has the authority to assess penalties of up to $1,000 a day for failure to file complete and timely annual 5500 reports. Under this program, the penalties are greatly reduced. The penalty a plan administrator would face depends on how late the filing is and what form should have been filed. For filings made late but within 12 months of the due date, the penalty will be $50 a day with a maximum of $2,500 for 5500 filers and $1,000 for 5500C/R filers. For returns filed more than 12 months after the due date, the maximum penalties are $5,000 for 5500 filers and $2,000 for 5500C/R filers. As can be seen, while these amounts are significant, they are much less than what the DOL could assess. Payment of these penalties may not come from plan assets. The plan administrator is liable for the penalty amount.

The last question is, "What about the IRS?" This program is a DOL program. The IRS also has the ability to assess penalties for late filing of 5500 forms. A look at the last DOL amnesty program may provide us with some guidance. In 1992 the DOL offered a program similar to DFVC in which the IRS did not participate. The general findings in the industry, however, were that the IRS was much more lenient in dealing with plan administrators who were filing under the DOL's program. This leniency included reduced IRS penalties, and abatement of many penalties that were owed. We would expect the same response from them under this DOL program.

Employers who have not filed 5500s in the past should strongly consider availing themselves of this program. While it may not be cheap, it is far less costly than waiting for the DOL to come to them. PD

✓ Check It Out ✓

Question: We have an IRA accountholder who wishes to transfer his IRA with us to another institution. He wants us to give him the transfer check so he can take it to the new custodian. Should we give him the check?

✓ Answer. While technically there is no express prohibition on giving the check to the accountholder and allowing him to take it to the new custodian, it is not recommended. In our view, too many things could and have gone wrong with situations like this. For example, the new custodian may view this as a rollover since the individual had the check. This will result in the erroneous reporting of a transfer to the IRS. Secondly, we have seen situations where the check was cashed without first being deposited into the IRA. Third, there have been cases where, for whatever reason, the check was never brought to the new custodian for a long period of time. This results in a loss of earnings for the individual. With a transfer, the best policy is to mail the check or wire the funds directly to the new custodian.

Question: We have an employer-customer who currently has a profit-sharing plan with our bank. She has asked us about a 401(k) plan to allow her employees to make salary-deferral contributions. Can this be done and how difficult is it?

✓ Answer. Yes, it can be done and usually quite easily. Since a 401(k) plan is considered to be a form of profit-sharing plan, its features can be added to an already existing profit-sharing plan. In many cases the plan document the employer has adopted already has 401(k) provisions in it. All that is necessary in that case is to simply amend the existing profit-sharing plan with a 401(k) adoption agreement. Obviously the bank would have to have the 401(k) adoption agreement available. Any bank who sponsors CWF's Qualified Plan prototype #01 has the ability to add 401(k) adoption agreements and offer 401(k) plans to its customers.

Question: We are confused about the magnetic media reporting requirements. We have 352 IRA accounts. We just completed our 5498 reporting in May on magnetic media. We have since discovered four 5498 reports with errors. Must the corrections be done on magnetic media?

✓ Answer. No. Magnetic media reporting for the Form 5498 has a threshold of 250 returns. This means that you are permitted to file this form on paper returns until you have 250 returns or more to file. This 250 threshold applies separately to corrected returns. This means that until you have 250 corrections to file, you can do them on paper even if the original filing was on magnetic media. And, of course, the four corrections can be submitted on magnetic media if you so choose. PD

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.