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## Withholding of Tax On IRA and Pension Distributions to Nonresident Aliens

Withholding is a confusing subject, and it is more so when the payee is an IRA accountholder or beneficiary who is a nonresident alien. The withholding topic is always one of great concern for a financial institution because tax penalties can be harsh for failing to do what the law requires. What the law requires is not all that clear, and IRA Publication 515, *Withholding of Tax On Nonresident Aliens and Foreign Corporations For Withholding in 1995*, gives little guidance with respect to IRAs. Special rules apply when the payee is a nonresident alien and special rules apply for distributions from pension plans and IRAs. In some cases it is not all that clear how these rules interrelate. The purpose of this article is to give our construction of these rules.

A nonresident alien is an individual who is not a U.S. citizen or a resident of the United States. Nonresident aliens must be distinguished from resident aliens because different withholding rules apply to resident aliens. The standard withholding rules which apply to U.S. citizens apply to resident aliens.

A resident alien is an alien (i.e. citizen of another country) who meets either the green-card test or the substantial-presence test for the calendar year. The following definitions are provided in Publication 515,

**"Green card test.** An alien is a U.S. resident if the individual was a lawful permanent resident of the United States at any time during the calendar year. This is known as the "green card" test because these aliens hold immigrant visas (also known as "green cards").

**Substantial presence test.** An alien is also considered a U.S. resident if the individual meets the substantial presence test for the calendar year. Under this test, the individual must be physically present in the United States on at least:

- 1) 31 days during the current calendar year, and
- 2) 183 days during the current year and the 2 preceding years, counting all the days of physical presence in the current year, but only 1/3 the number of days present in the first preceding year, and only 1/6 the number of days in the second preceding year.

You generally do not count days the alien is in the

United States as a teacher, student, or trainee on an "F," "J," "M," or "Q" visa."

There are numerous reasons why an IRA is a unique type of retirement savings plan. One of the reasons is that the IRA account must be established in the United States. A person is eligible to make an IRA contribution only for a tax year he or she had personal-service income subject to taxation by the United States. This means the person, when he or she made the contribution, was not a nonresident alien. The status of a person may change, or the person may die and the beneficiary may be a nonresident alien. You need to be aware that such changes will affect the withholding rules and rates which apply to a distribution.

There are three main sections of the Internal Revenue Code which need to be reviewed. They are: section 871, section 1441 and section 3405.

Code section 871 is titled, "Tax on Nonresident Alien Individuals." A flat tax rate of 30% is applied to all income which is not connected with a United States business conducted by a nonresident alien. A 14% rate applies to certain specifically-defined income items. Some items of income are not subject to this tax (e.g. certain interest and dividends) and in some cases special rules apply. A detailed discussion of section 871 is beyond the scope of this article. Section 871 does not specifically define distributions from IRAs as being a type of income subject to the 30% tax. However, the definition of the income which is taxable is so broad that one can reasonably conclude that IRA distributions are such income.

The basic concept is — the United States, via its agent, the IRS, wants to collect the tax revenues it is due from each nonresident alien who has "income" somehow related to the United States. The taxation issues which arise when a taxpayer accrues his pension or IRA in one state and then moves to another state is very similar to when a person accrues his pension or IRA

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Truth  
in  
Savings

## TISA's Disclosure Requirements for "Maturing" Time Deposits/Accounts

Under current law, the Truth in Savings Act does apply to IRA funds which are invested in savings and time deposits. There is proposed legislation in Congress now which would repeal most of TISA's provisions. The fate of this legislation is uncertain considering the relationship which exists between President Clinton and the Republicans. TISA requires a financial institution to furnish a depositor with a disclosure in various situations. The intent of this article is not to discuss the rules for all situations. The purpose of the article is to discuss those rules which apply when a time account approaches maturity. These rules apply to both IRA and non-IRA time accounts or deposits. Your institution must have procedures in place to ensure compliance with these rules.

Prior to TISA, it was very common for financial institutions and data processors to send out a very concise or simple notice that a certificate of deposit would be maturing. An institution's continued use of such a simple notice means there will be noncompliance with TISA's requirements.

TISA creates five different types of "maturity" notices. The content of each of these five notices differs, as does the deadline to furnish them.

Federal Reserve Regulation 230.5 sets forth governing rules. This regulation, in effect, creates the following five categories.

### Notice #1

**The Notice (i.e. Disclosure) Required To Be Furnished For Time Accounts**

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◆ Problems with Direct Rollovers Page 5

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#### **Withholding—Continued from page 1**

in the United States and then moves to a foreign country. The source where the income tax was originally deferred now wants to collect its tax. The general rule of Code section 871 is — if a person has fixed or determinable annual or periodic income from sources in the United States, this income is subject to withholding and taxation by the United States. Such income includes interest, dividends, rents, salaries, wages, premiums, annuities, pensions or other gains, profits, or income unless specifically exempted under the Internal Revenue Code or a tax treaty.

Code section 1441 is titled, "Withholding of Tax on Nonresident Aliens." The general rule is set forth that a payor must withhold from certain defined income types a tax equal to 30%. Again, there are exemptions or exceptions. Some income is only subject to withholding at the rate of 14%. The main exemption is that there is to be no withholding in the case of any income (other than compensation for personal services) which is effectively connected with the conduct of a trade or business within the United States and which is included in the gross income of the recipient under section 871(b)(2). Again, this section does not specifically define IRA distributions as being the type of income subject to withholding at the rate of 30%, but the definition is so broad that the reasonable conclusion is that IRA distributions are subject to withholding at the 30% rate. The withholding required by section 1441 is mandatory, and the recipient does not have the ability to waive it. However, a tax treaty may provide for a lower rate.

The fact that the tax rate and the withholding rate is the same 30% is not a coincidence. Why? A nonresident alien need not file an income tax return if such person was not engaged in a trade or business in the United States at any time during the tax year and if the tax liability for such person was fully satisfied by the withheld tax amount at the source.

Code section 3405 is titled, "Special Rules For Pensions, Annuities, And Certain Other Deferred Income." The general rule of Code section 3405(c) is that there is mandatory 20% withholding for a designated distribution which is an "eligible rollover distribution." The general rule of Code section 3405(a) and (b) is that the recipient has the ability to waive withholding for those periodic and nonperiodic distributions which do not qualify as "eligible rollover distributions." IRA distributions do not qualify as "eligible rollover distributions."

#### **What duty is there for an IRA custodian to determine if a person is a nonresident alien?**

You are required to apply a facts and circumstances test. If the facts indicate that the person is a nonresident alien, then

you must apply the "nonresident alien" withholding rules.

The IRS makes the following statement in Publication 515, on page 3, Withholding of Tax on Nonresident Aliens and Foreign Corporations for Withholding in 1995.

"Evidence of residence. If an individual gives you a written statement that he or she is a citizen or resident of the United States, and you do not know otherwise, you do not have to withhold tax under the rules discussed in this Publication. Instead, get Publication 15, Circular E, Employer's Tax Guide. An alien may claim U.S. residence by filing with you, Form 1078, Certificate of Alien Claiming Residence in the United States. Keep the statement or form for your records. Do not file with the IRS."

An IRA custodian, therefore, may treat an alien as a nonresident alien unless he or she furnishes you a written (Form 1078) that he or she is a resident alien.

#### **What Withholding Rules Apply to IRA and Pension Distributions to a Nonresident Alien?**

In Publication 515, the IRS states the following on page 12,

"Pensions and annuities. Generally, you must withhold tax on the gross amount of pensions and annuities that you pay. However, most tax treaties provide that private pensions and annuities are exempt from withholding.

A pension paid to a nonresident alien as a result of services performed by the alien in the United States is treated as income effectively connected with a U.S. trade or business. This income is generally subject to graduated withholding rules of Code section 3405. See Publication 15, Circular E, Employer's Tax Guide, for information on these rules.

Each individual who receives a pension fills out Form W-4P, Withholding Certificate for Pension or Annuity Payments, to claim withholding allowances and to show marital status for withholding purposes. When the nonresident alien completes Form W-4P, only "Single" marital status should be checked and only one withholding allowance is allowed, unless the alien is a resident of Canada, Mexico, Japan, or South Korea, or is a U.S. national. A U.S. national is an individual who is either a citizen of American Samoa, or a Northern Mariana Islander who chose to become a U.S. national.

Under section 3405, an alien may elect not to have tax withheld on periodic pension payments or nonperiodic pension distributions.

However, if the alien makes this no withholding election for the graduated tax, the pension income is subject to the 30% (or lower treaty rate) withholding tax."

To summarize, a nonresident alien under section 3405 may in some cases elect to not have income tax withheld on the pension distribution. Form W-4P or a substitute Form W-4P is used to make this election. However, if the nonresident alien makes this election, then the 30% withholding tax rate applies unless there is a tax treaty which provides for a lower rate. Most tax treaties provide that private pensions and annuities are exempt from withholding. A summary of the tax treaties is set forth in the special insert.

Examples. Else (age 72) is currently a citizen of Denmark. Mark (age 73) is cur-

rently a citizen of Canada. Paul (age 71) is currently a citizen of Chile. All three worked in previous years in the United States and accrued a pension benefit under their employer's pension plan. They are now being paid their accrued benefit over a period longer than ten years. Thus, the 20% mandatory withholding rule does not apply. All three elect no withholding under section 3405. What withholding rate will apply to each distribution?

The distribution to Else will not be subject to any withholding rate since the treaty rate with Denmark is zero.

The distribution to Mark will be subject to the 15% since that is what the treaty with Canada provides with respect to annuities and pensions.

The distribution to Paul will be subject to the rate of 30% since with Chile there is no treaty providing a different rate.

#### **Who Has the Burden of Determining if a Tax Treaty Applies?**

The foreign resident (nonresident alien), generally, must notify you, as the withholding agent, that they are residents of a country with which the United States has an income tax treaty and that they qualify for reduced rates of, or exemption from, income tax withholding. The rate which applies may vary under each treaty. Thus, you must check the tax treaty summary for the applicable country.

#### **What Reporting Forms Must be Completed by the Withholding Agent?**

If withholding takes place under the authority of Code section 3405, then the transmittal form to be used by the payor (your financial institution) is Form 945, Annual Return of Withheld Federal Income Tax to summarize the income tax withheld from the IRA/pension distributions. The Form 1099-R would be furnished to the IRA or pension distribution recipient.

If withholding takes place under the authority of Code section 1441, then the transmittal form to be used by the payor (your financial institution) is Form 1042, Annual Withholding Tax Return For U.S. Source Income of Foreign Persons. The authority for this statement is page 3 of the 1994 Instructions for Forms 1042 and 1042-S which states,

"Income tax Withholding on Wages, Pensions, Annuities, and Certain Other Deferred Income

Use Form 941, Employer's Quarterly Federal Tax Return, to report income tax withheld under section 3402 from wages paid to a nonresident alien employee.

Use Form 945, Annual Return of Withheld Federal Income Tax, to report income tax withheld under section 3405 from pensions, annuities, and certain other deferred income paid to a nonresident alien individual. However, if the recipient has elected under section 3405(a)(2) or (b)(2) not to have withholding under section 3405, such

*Continued on page 3*



# **Withholding—Continued from page 2**

payments are subject to withholding under section 1441 and the tax withheld is to be reported using Forms 1042 and 1042-S. Use Form 942, Employer's Quarterly Tax Return for Household Employees, to report social security and Medicare taxes, and any income tax withheld, on wages paid to an employee. For more information, see the instructions to these forms and Publication 15 (Circular E), Employer's Tax Guide."

## **Discussion of Form 1042 and 1042-S**

Form 1042 is titled, "Annual Withholding Tax Return For U.S. Source Income of Foreign Persons." Form 1042 is used to transmit the individual Form 1042-S. You must file Form 1042 whether or not any tax was withheld or was required to be withheld if you are required to file Form 1042-S.

Form 1042-S is titled, "Foreign Person's U.S. Source Income Subject to Withholding." This form is issued to a specific person, and a copy is sent to the IRS as is done with W-2s, 1099-Rs, etc.

Your financial institution is required to complete a Form 1042-S for each IRA accountholder or IRA beneficiary who receives a distribution and who is a non-resident alien, and who elected not to have withholding under Code section 3405. You must file a Form 1042-S even if:

(1) You did not withhold tax because the income was exempt from tax under a

U.S. tax treaty or the Code, including the exemption for income effectively connected with conducting a trade or business in the United States; or

(2) You released the tax withheld to the recipient.

A copy of the 1994 Form 1042-S is set forth below:

The deadline for furnishing the Form 1042 and 1042-S to the IRS is March 15, 19xx. You must also furnish a Form 1042-S to the recipient of the income. Magnetic

media reporting rules do apply (i.e. 250 or more). Deposit requirements also apply. Generally, you must deposit the tax withheld and required to be shown on Form 1042 within time deadlines with an authorized financial institution or a Federal Reserve bank or branch using Form 8109-A Federal Tax Deposit Coupon. Standard penalties apply for late deposits or incorrect preparation of these forms.

*Continued on page 4*

Form <b>1042-S</b>		<b>Foreign Person's U.S. Source Income Subject to Withholding</b>		<b>1994</b>		OMB No. 1545-0096		
Department of the Treasury Internal Revenue Service		For Paperwork Reduction Act Notice, see separate instructions for Forms 1042 and 1042-S.				<b>Copy A for Internal Revenue Service</b>		
Line	(a) Income code	(b) Gross income paid	(c) Withholding allowances (for income code 15 or 16 only)	(d) Net income (column (b) minus column (c))	(e) Tax rate (%)	(f) Exemption code	(g) U.S. Federal tax withheld (net of any tax released)	(h) Country code
1								
2								
3	Total							
4 Recipient code (see instructions) ▶				9 WITHHOLDING AGENT'S name and address (including ZIP code) (as shown on Form 1042)				
5 Recipient's U.S. taxpayer identification number, if any ▶								
6 Account number (optional) ▶								
7 RECIPIENT'S name (first name, initial, and last name), street address, city, province or state, postal code, and country								
				10 Withholding agent's taxpayer identification number (TIN)				
				11 PAYER'S name and TIN (if different from withholding agent's)				
				12 State income tax withheld				
8 Recipient's country of residence for tax purposes (see instructions)				13 Payer's state tax number		14 Name of state		

Cat. No. 11386R Form **1042-S** (1994)

**Table 1. Withholding Tax Rates on Income Other Than Personal Service Income Under Chapter 3, Internal Revenue Code, and Income Tax Treaties—For Withholding in 1995**

Income code number		1	2	3	6	7	9	10	11	12	13	14
Country of residence of payee					Dividends paid by				Copyright royalties <sup>dd</sup>			
Name	Code	Interest paid by U.S. obligors General <sup>dd</sup>	Interest on real property mortgages <sup>dd</sup>	Interest paid to controlling foreign corporations <sup>dd</sup>	U.S. Corporations General <sup>dd</sup>	U.S. subsidiaries to foreign parent corporations <sup>dd</sup>	Capital Gains <sup>dd</sup>	Industrial Royalties <sup>dd</sup>	Motion Pictures and Television	Other	Real Property Income and Natural Resources Royalties <sup>dd</sup>	Pensions and Annuities
Australia	AS	910	910	910	915	915	30	910	910	910	30	90
Austria	AU	90	30	90	915	915	30	90	910	90	30	90
Barbados	BB	95	95	95	915	915	90	95	95	95	30	90
Belgium	BE	915	915	915	915	915	90	90	90	90	30	90
Canada	CA	915	915	915	915	910	30	910	910	90	30	915
China, People's Republic of	CH	910	910	910	910	910	30	910	910	910	30	90
Commonwealth of Independent States		90	30	30	30	30	90	0	0	0	30	30
Cyprus	CY	910	910	910	915	915	90	90	90	90	30	90
Czech Republic	EZ	90	90	90	915	915	90	910	90	90	30	90
Denmark	DA	90	90	90	915	915	30	90	90	90	30	90
Egypt	EG	915	30	915	915	915	90	90	90	915	30	90
Finland	FI	90	90	90	915	915	90	95	90	90	30	90
France	FR	90	90	90	915	915	90	95	90	90	30	90
Germany	GM	90	90	90	915	915	90	90	90	90	30	90
Greece	GR	90	90	30	30	30	30	90	90	90	30	90
Hungary	HU	90	90	90	915	915	90	90	90	90	30	90
Iceland	IC	90	90	90	915	915	90	90	90	90	30	90
India	IN	915	915	915	915	915	30	910	910	910	30	90
Indonesia	ID	915	915	915	915	915	90	910	915	915	30	915
Ireland	EI	90	90	30	915	915	30	90	90	90	30	90
Italy	IT	915	915	915	915	915	90	910	910	910	30	90
Jamaica	JM	912 1/2	912 1/2	912 1/2	915	915	90	910	910	910	30	90
Japan	JA	910	910	910	915	915	90	910	910	910	30	90
Korea, Rep. of	KS	912	912	912	915	915	90	910	910	910	30	90
Luxembourg	LU	90	30	90	915	915	30	90	90	90	30	90
Malta	MT	912 1/2	912 1/2	912 1/2	915	915	90	910	910	910	30	90
Mexico	MX	915	915	915	915	915	90	910	910	910	30	90
Morocco	MO	915	915	915	915	915	90	910	910	910	30	90
Netherlands	NL	90	90	90	915	915	90	90	90	90	30	90
Netherlands Antilles, Aruba	NA, AA	90	30	30	30	30	30	30	30	30	30	30
New Zealand	NZ	910	910	910	915	915	90	910	910	910	30	90
Norway	NO	90	90	90	915	915	90	910	910	910	30	90
Pakistan	PK	30	30	30	30	30	30	90	90	90	30	90
Philippines	RP	915	915	915	915	915	90	910	910	910	30	90
Poland	PL	90	90	90	915	915	90	910	910	910	30	90



**Withholding—Continued from page 3**  
**What About Social Security Numbers?**

As illustrated in the preceding discussions, the IRA or pension distribution to a nonresident alien will take place under either Code section 3405 or section 1441. The rules with respect to your need for social security numbers are different under these two sections.

You will always have the social security number of the IRA accountholder since he or she would have had to have one to establish the IRA. You will not always have a social security number for a beneficiary of an IRA who is a nonresident alien.

Under Code section 3405, the IRS has taken the position that if the payee does not furnish you with a social security number, then you must ignore the person's request to have no income tax withheld. That is, you must withhold if the payee has no social security number.

Under Code section 1441, a nonresident alien who has income which is effectively connected with a U.S. trade or business must obtain and furnish you with a tax identification number. A nonresident alien who is not effectively connected with a U.S. business and does not have an office in the United States is not required to have a United States tax identification number.

The IRA beneficiary would like to use section 1441 because the existence of a treaty in most cases will mean the withholding rate is zero. The catch 22 is this—although section 1441 does not require the nonresident alien to have a social security number, section 3405 does. Thus, one is needed. If one is not obtained, you, as the IRA custodian, will need to withhold at the rate of 10%.

**Conclusion**

The tax and withholding rules which apply for IRA and pension distributions to nonresident aliens are complex. IRS

assistance in making these rules a little clearer would be helpful.

Your standard procedure will be to furnish the nonresident alien (accountholder or beneficiary) a copy of your standard IRA distribution and withholding Form W-4P. This person may instruct you that he or she does not want withholding. To do this, he or she must furnish you with a social security number. You then must withhold at the rate of 30% unless the person instructs you in writing that a treaty applies and that a lower rate (probably 0) applies. Note that you have no duty to furnish any type of notice to the nonresident alien explaining that since they are a nonresident alien that there might be a treaty which applies which would provide for a lower withholding rate. You may choose to do this as a customer service. **B**

Table 1. (Continued)

Income code number		1	2	3	6	7	9	10	11	12	13	14
Country of residence of payee		Interest paid by U.S. obligors General <sup>dd</sup>	Interest on real property mortgages <sup>dd</sup>	Interest paid to controlling foreign corporations <sup>dd</sup>	Dividends paid by		Capital Gains <sup>u,dd</sup>	Industrial Royalties <sup>dd</sup>	Copyright royalties <sup>dd</sup>		Real Property Income and Natural Resources Royalties <sup>u</sup>	Pensions and Annuities
Name	Code				U.S. Corporations General <sup>u,dd</sup>	U.S. subsidiaries to foreign parent corporations <sup>u,dd</sup>			Motion Pictures and Television	Other		
Romania .....	RO	910	910	910	910	910	910	915	910	910	30	0
Russia .....	RS	90	900	90	910	915	910	90	90	90	30	0
Slovak Republic .....	LO	90	900	90	915	915	910	910	90	90	30	0
Spain .....	SP	910	910	910	915	910	910	915	915	915	30	0
Sweden .....	SW	90	90	90	915	915	910	0	0	0	30	0
Switzerland .....	SZ	915	915	915	915	915	910	910	910	910	30	0
Trinidad & Tobago .....	TD	30	30	30	30	30	30	915	30	90	30	0
Tunisia .....	TS	915	915	915	915	915	910	910	915	915	30	0
United Kingdom .....	UK	90	90	90	915	915	910	910	910	910	30	0
Other countries .....		30	30	30	30	30	30	30	30	30	30	30

\* No U.S. tax is imposed on a percentage of any dividend paid by a U.S. corporation that received at least 80% of its gross income from an active foreign business for the 3-year period before the dividend is declared. (See sections 871(i)(2)(B) and 881(d) of the Internal Revenue Code.)

<sup>b</sup> The reduced rate applies to dividends paid by a subsidiary to a foreign parent corporation that has the required percentage of stock ownership. In some cases, the income of the subsidiary must meet certain requirements (e.g., a certain percentage of its total income must consist of income other than dividends and interest). In the case of Italy, the reduced rate is 10% if the foreign corporation owns 10% to 50% of the voting stock (for a 12-month period) of the company paying the dividends.

<sup>c</sup> The exemption or reduction in rate applies only if the recipient is subject to tax on this income in the country of residence. Otherwise a 30% rate applies.

<sup>d</sup> Exemption does not apply to U.S. Government (federal, state, or local) pensions and annuities; a 30% rate applies to these pensions and annuities. U.S. government pensions paid to individuals who are both residents and nationals of Finland, India, Malta, Mexico, The Netherlands, Russia, Spain, or the United Kingdom are exempt from U.S. tax.

<sup>e</sup> The treaty exemption that applies to U.S. source capital gains includes capital gains under section 871(a)(2) if they are received by a nonresident alien who is in the U.S. for not more than 183 days. (182 days for Belgium and Egypt.)

<sup>f</sup> Includes alimony.

<sup>g</sup> Under the treaty the exemption or reduction in rate does not apply if the recipient has a permanent establishment in the United States and the property giving rise to the income is effectively connected with this permanent establishment. In the case of Australia, Barbados, Canada, China, Cyprus, the Czech Republic, Finland, France, Germany, Hungary, India, Indonesia, Italy, Jamaica, Malta, Mexico, the Netherlands, New Zealand, Philippines, Russia, the Slovak Republic, Spain, Tunisia, and the United Kingdom, the exemption or reduction in rate also does not apply if the property giving rise to the income is effectively connected with a fixed base in the United States from which the recipient performs independent personal services (professional services for royalties paid to a Philippines resident). Even with the treaty, if the income is not effectively connected with a trade or business in the United States by the recipient, the recipient will be considered as not having a permanent establishment in the United States under IRC section 894(b).

<sup>h</sup> Under the treaty the exemption or reduction in rate does not apply if the recipient is engaged in a trade or business in the United States through a permanent establishment that is in the United States. However, if the income is not effectively connected with a trade or business in the United States by the recipient, the recipient will be considered as not having a permanent establishment in the United States for the purpose of applying the reduced treaty rate to that item of income. IRC section 894(b).

<sup>i</sup> Bangladesh has not indicated that it wishes to assume the responsibilities or exercise the rights of the United States—Pakistan income tax treaty.

<sup>j</sup> Exemption is not available when paid from a fund, under an employees' pension or annuity plan, if contributions to it are deductible under U.S. tax laws in determining taxable income of the employer.

<sup>k</sup> Exemption from or reduction in rate of tax does not apply to income of holding companies entitled to special tax benefits under the laws of Luxembourg.

<sup>l</sup> Exemption does not apply to gains from the sale of real property. Treaty terminated January 1, 1988, except that the exemption from tax provided in Article VIII for certain interest will remain in force.

<sup>m</sup> The exemption applies only to interest on credits, loans, and other indebtedness connected with the financing of trade between the United States and the C.I.S. member countries. It does not include interest from the conduct of a general banking business.

<sup>n</sup> The exemption applies only to gains from the sale or other disposition of property acquired by gift or inheritance.

<sup>o</sup> The exemption does not apply if the recipient was a resident of the United States when the pension was earned or when the annuity was purchased.

<sup>p</sup> Annuities paid in return for other than the recipient's personal services are exempt.

<sup>q</sup> Generally, if the property was owned by the Canadian resident on September 26, 1980, not as part of the business property of a permanent establishment or fixed base in the U.S., the taxable gain is limited to the appreciation after 1984. Capital gains on personal property not belonging to a permanent establishment or fixed base of the taxpayer in the U.S. are exempt.

<sup>r</sup> Under the treaty, the reduced rate for royalties with respect to tangible personal property is 7%.

<sup>s</sup> Does not include alimony; for Canada, alimony is exempt. For Indonesia, alimony is subject to a 30% rate.

<sup>t</sup> Withholding at 30% may not be required on the disposition of U.S. real property interests. See U.S. Real Property Interest earlier in this publication.

<sup>u</sup> Tax imposed on 70% of gross royalties for rentals of industrial, or scientific equipment.

<sup>v</sup> The rate in column 6 applies to dividends paid by a regulated investment company (RIC) or a real estate investment trust (REIT). However, the reduced rate does not apply to dividends paid by a REIT if the beneficial owner of the dividends is an individual holding a 10% or greater interest (25% or greater interest for the Netherlands, Spain and Tunisia) in the REIT. In that case, a 30% rate applies.

<sup>w</sup> Royalties not taxed at the 5% or 8% rate are taxed at a 10% rate, unless footnote (g) applies.

<sup>x</sup> The exemption does not apply if the recipient of the gain is an individual who is present in the United States for more than 119 days during the year.

<sup>y</sup> The rate is 10% if the interest is paid on a loan granted by a bank or similar financial institution.

<sup>z</sup> This is the rate for royalties for the use of, or the right to use, industrial, commercial, and scientific equipment. The rate for royalties for information concerning industrial, commercial and scientific know-how is subject to the rate in column 12, but use Income Code 10 for reporting purposes.

<sup>aa</sup> The rate is 15% if the payor of royalties is the Federal, state, or local government or a public sector company.

<sup>ab</sup> The exemption does not apply to cinematographic films, or works on film, tape, or other means of reproduction for use in radio or television broadcasting.

<sup>ac</sup> Under some treaties, the reduced rates of withholding may not apply to a foreign corporation unless a minimum percentage of its owners are citizens or residents of the United States or the treaty country.

<sup>ad</sup> Exemption does not apply to an excess inclusion for a residual interest in a real estate mortgage investment conduit (REMIC).

<sup>ae</sup> The rate in column 6 applies to dividends paid by a regulated investment company (RIC). Dividends paid by a real estate investment trust (REIT) are subject to a 30% rate.

<sup>af</sup> The exemption does not apply to the gain on the sale of personal property forming part of the business property of a permanent establishment that an enterprise has in the United States or pertaining to a fixed base available in the United States for the purpose of performing independent personal services.

<sup>ag</sup> The rate is 10% for interest derived from (1) loans granted by banks and insurance companies and (2) bonds or securities are regularly and substantially traded on a recognized security market.

<sup>ah</sup> The exemption does not apply if (1) the recipient was a U.S. resident during the 5-year period before the date of payment, (2) the amount was paid for employment performed in the United States, and (3) the amount is not a periodic payment, or is a lump-sum payment in lieu of a right to receive an annuity.



## Problems with Direct Rollovers

Most IRA custodians are happy with the law change which brought about direct rollovers. Most IRA custodians have received the majority of their IRA deposits from these direct rollovers since the amount of "regular" contributions have decreased substantially as the tax deduction for such contributions was eliminated or reduced. Direct rollovers came into being on January 1, 1993, and occur when a participant instructs the plan administrator of his qualified plan or section 403(b) annuity plan that he wants his account balance, which otherwise would have been distributed, sent directly to an IRA, another qualified plan, or a section 403(b) annuity plan.

A direct rollover may look like a direct transfer since the check is made payable to your financial institution, but it is not. A nonreportable transfer occurs only if the funds or assets are moving between the same type of plan (QP to QP, 403(b) to 403(b), or IRA to IRA).

The new direct rollover rules expressly require the plan administrator to determine what portion of a participant's account qualifies to be directly rolled over. The entire account may qualify, or only a portion of it may qualify. It would be great if the plan administrator always determined the proper amount which was eligible to be rolled over. The world is not such a nice place. As with rollovers, "problems" can occur. Set forth are some "problems" and our suggestions as to how the IRA custodian/trustee should respond. To a certain degree the problems of your customers become your problems.

**Problem/Situation #1.** Your institution (First Integrity Bank) has just received a cashier's check; or another bank's check, which lists the payee as "First Integrity Bank for the IRA of Susan Edder."

Without more information, you do not know how to properly process this check. Is it a rollover or a transfer?

If the payor of the check was an IRA custodian/trustee, then you probably could handle it as a transfer. Transfers are not reportable on the Form 5498.

If the payor of the check was a QP plan or a bank on behalf of a QP plan, then you need to handle it as a direct rollover because direct rollovers are reportable in box 2 of the Form 5498.

You will need to contact Susan Edder. She will need to furnish you with some additional information. You should not commingle these funds with an existing IRA which she maintains without her authorizing such a commingling. You could deposit it to a new IRA if you have the ability to change the type of contribution from rollover to transfer or vice versa.

Any time there is a direct rollover, the IRA custodian/trustee, if at all possible, wants to receive a copy of the section 402(f)

notice which the plan administrator should have furnished the participant/IRA accountholder. Why? This shows what amount, if any, the participant was entitled to directly roll over and what amount they actually did roll over. Employer and qualified plan administrators do not always understand the rules as they should. If the IRA custodian/trustee cannot obtain a copy of the section 402(f) notice, then it will want to have Susan Edder complete a rollover certification form containing the following provision or a very similar provision:

**"Complete this section for a direct rollover of QP/annuity funds to an IRA.**

*I instructed my former employer/plan administrator to send you, as my IRA custodian/trustee, a direct rollover contribution. The plan administrator has either furnished you or me with a check made payable to you as the IRA custodian. You now have possession of this check and/or other similarly titled assets. The plan administrator:*

☐ a. has; or

☐ b. has not sent you any additional information certifying that the assets which were sent are eligible to be rolled over. I expressly assume all responsibility for the determination that the assets which are sent are eligible to be rolled over.

*I have indicated below whether or not I intend to keep the funds segregated for rollover purposes."*

**Problem/Situation #2.** A QP plan administrator sends a check for \$26,400 to Sheila Brucatto. The \$26,400 was Sheila's entire account balance. The check is made payable to First Federal Savings Bank as IRA custodian for Sheila Brucatto. The check was mailed January 15, 1995, and she received it January 20, 1995. She set this check in her "to handle later" file at home. It is now later (August 29, 1995). She is standing in front of you and she now wishes to create her IRA and deposit the check into this account.

The 60-day rule does not apply to direct rollovers. It only applies if a person is actually in receipt of the funds, and Susan was not, as she was not the payee of the check. First Federal Savings Bank should set up the IRA for Sheila Brucatto and send the check through the normal channels. It appears that some QP plan administrators are not real diligent in balancing their checkbook. Although a QP plan administrator may at some point put a stop payment order in effect on an "old check," this doesn't seem to happen very often.

**Problem/Situation #3.** Sheila Brucatto is not an easy person to deal with. She decides on September 15, 1995, that she wants to move her \$26,400 (less interest penalty) to a different financial institution and she does not want to tell you the name of that institution. Will the "once-per-12-month rollover rule" prevent her from having the check made payable to herself?

No. The rule which limits rollovers to once-per-12-month period only applies to distributions from IRAs. In this situation, there has only been this one distribution

from the IRA and it can be rolled over.

Another question — Because the original source of the IRA distribution was a QP plan, does that mean that you, as the IRA custodian, must withhold 20%? No. This is a distribution from an IRA, and the account holder has the right to instruct the IRA custodian that she doesn't want withholding.

**Problem/Situation #4.** Raul Barry has recently separated from service with Appovon, Inc. He has an account balance of \$74,800. He has been a plan participant since 1975. He has made nondeductible contributions of \$2,800. This \$2,800 is not eligible to be rolled over. Nevertheless, Appovon, Inc. sends a check for the full amount of \$74,800 to your institution (First Grand Bank). You deposit the full \$74,800. On March 10, 1996, Raul goes to his accountant and is told that the \$2,800 should not have been rolled over. Raul calls you.

Raul made an excess contribution to the extent of \$2,800, since this amount was not eligible to be rolled over. Raul will need to instruct you how he will correct this excess contribution. It is our opinion that your institution does not have any liability since the duty to determine what portion of a distribution is eligible to be rolled over rightfully falls on the plan administrator since it has the necessary information.

**Problem/Situation #5.** Beatrice Cannon has recently separated from service with BAT, Inc. She has an account balance of \$126,900. She has instructed that these funds be sent directly to your institution (First Integrity). Plus, she will be allocated a contribution of \$6,000 for that portion of the 1995 year during which she has worked. She will not be entitled to receive this amount until January of 1996.

The fact that there will be two checks issued in two different years to First Integrity on behalf of Beatrice Cannon does not create any problems. The "once-per-12-month rollover rule" does not apply to distributions from QP plans. Both checks may be deposited into the same IRA (plan agreement and/or investment).

**Problem/Situation #6.** Michael Wilton, age 66, recently retired from MCC Telephone Company. He was a participant in the MCC Telephone Company Employees' Defined Benefit Pension Plan. On October 2, 1995, he was told his lump-sum benefit was \$84,878. He instructed the plan administrator on October 16, 1995, that he wanted this entire amount directly rolled over to your institution (First National Bank). You received the check on October 19, 1995, and deposited it immediately into a fixed-interest-rate time deposit with a term of 24 months. This plan sent him a letter on July 2, 1995, stating that they have just realized that he should only have been paid the amount of \$76,675. They want him to repay the overpayment amount of \$8,203. The plan

*Continued on page 6*



## That Renew Automatically With an Original Term of More Than One Year

### Required Content of Notice #1

1. All information required for a new account, see the summary set forth at the end of this article;
2. The date the account matures; and
3. If the interest rate and annual percentage yield to be paid the "renewed account" after its maturity are unknown at the time this notice is sent, there shall be a statement on the disclosure that these rates have not yet been determined, the date they will be determined, and a telephone number which can be called to obtain these rates. If these rates are known at the time of the disclosure, furnish these rates.

### Deadline For Furnishing Notice #1

This disclosure must be mailed or delivered at least 30 calendar days before the existing account matures.

Alternatively, this disclosure may be mailed at least 20 calendar days before the end of the grace period for an existing account provided the grace period is at least 5 days.

### Notice #2

## The Notice (i.e. Disclosure) Required to be Furnished for Existing Time Accounts That Renew Automatically With an Original Term of One Year or Less But Longer Than One Month

### Required Content of Notice #2

1. The date the existing account matures and the new maturity date if the account is renewed;
2. If known, the interest rate and the annual percentage yield for the renewed account.

If unknown, a statement on the disclosure that these rates have not yet been determined, the date they will be determined, and a telephone number which can be called to obtain these rates.

3. Any difference in the terms of the renewed account as compared to the existing/maturing account.

### Deadline For Furnishing Notice #2

The same deadline as described above for accounts with a term of longer than one year apply. This disclosure must be mailed or delivered at least 30 calendar days before the existing account matures. Alternatively, this disclosure may be mailed at least 20 calendar days before the end of the grace period provided the grace period is at least 5 days.

### Notice #3

## The Notice (i.e. Disclosure) Required to be Furnished for Existing Time Accounts That Renew Automatically With an Original Term of One Month or Less.

### Required Content of Notice #3

There must be an explanation if there is any difference in the terms of the renewed account as compared to the existing/maturing account. However, you are not required to furnish a change in the interest rate and the corresponding

change in the annual percentage yield.

### Deadline For Furnishing Notice #3

The notice shall be mailed or delivered within a reasonable time after the renewal.

### Notice #4

## The Notice (i.e. Disclosure) Required to be Furnished for Time Accounts That Don't Renew Automatically With an Original Term of More Than One Year

### Required Content of Notice #4

The maturity date and whether interest will be paid after maturity.

### Deadline For Furnishing Notice #4

This disclosure must be mailed or delivered at least 10 calendar days before the existing account matures.

### Category #5

## The Notice (i.e. Disclosure) for Time Accounts That Don't Renew Automatically With an Original Term of One Year or Less

There is no required notice. That is, the financial institution is not required to furnish a notice to accounts which are in this category.

### Summary

Since most time deposits renew automatically, your institution will need to send the proper disclosure notice prior to the actual maturity date.

The proper maturity notice depends upon the term of the existing time account.

### Required Contents of Account Disclosure

(1) *Rate information*—(i) *Annual percentage yield and interest rate.* The "annual percentage yield" and the "interest rate," using those terms, and for fixed-rate accounts the period of time the interest rate will be in effect.

(ii) *Variable rates.* For variable-rate accounts:

- (A) The fact that the interest rate and annual percentage yield may change;
- (B) How the interest rate is determined;
- (C) The frequency with which the interest rate may change; and
- (D) Any limitation on the amount the interest rate may change.

(2) *Compounding and crediting*—(i) *Frequency.* The frequency with which interest is compounded and credited.

(ii) *Effect of closing an account.* If consumers will forfeit interest if they close the account before accrued interest is credited, a statement that interest will not be paid in such cases.

(3) *Balance information*—(i) *Minimum balance requirements.* Any minimum balance required to:

- (A) Open the account;
- (B) Avoid the imposition of a fee; or
- (C) Obtain the annual percentage yield disclosed.

Except for the balance to open the account, the disclosure shall state how the balance is determined for these purposes.

(ii) *Balance computation method.* An explanation of the balance computation method specified in § 230.7 of this part used to calculate interest on the account.

(iii) *When interest begins to accrue.* A statement of when interest begins to accrue on noncash deposits.

(4) *Fees.* The amount of any fee that may be imposed in connection with the account (or an explanation of how the fee will be determined) and the conditions under which the fee may be imposed.

(5) *Transaction limitations.* Any limitations on the number or dollar amount of withdrawals or deposits.

(6) *Features of time accounts.* For time accounts:

- (i) *Time requirements.* The maturity date.
- (ii) *Early withdrawal penalties.* A statement that a penalty will or may be imposed for early withdrawal, how it is calculated, and the conditions for its assessment.

(iii) *Withdrawal of interest prior to maturity.* If compounding occurs during the term and interest may be withdrawn prior to maturity, a statement that the annual percentage yield assumes interest remains on deposit until maturity and that a withdrawal will reduce earnings. For accounts that do not compound interest on an annual or more frequent basis, with a stated maturity greater than one year that require interest payouts at least annually and that disclose an APY determined in accordance with section E of Appendix A of this part, a statement that interest cannot remain on deposit and that payout of interest is mandatory.

(iv) *Renewal policies.* A statement of whether or not the account will renew automatically at maturity. If it will, a statement of whether or not a grace period will be provided and, if so, the length of that period must be stated. If the account will not renew automatically, a statement of whether interest will be paid after maturity if the consumer does not renew the account must be stated.

(7) *Bonuses.* The amount or type of any bonus, when the bonus will be provided, and any minimum balance and the time requirements to obtain the bonus. **B**

### Direct Rollovers—Continued from page 5

has written both you and Mr. Wilton asking that they receive a check as soon as possible.

Errors do occur in calculating a terminated participant's vested accrued benefit. You must remember that you, as an IRA custodian, owe your duty to Mr. Wilton. He, of course, should discuss this situation with his legal and tax advisor. There may be some tax problems since there has been an excess contribution in withdrawing this amount and most advisors would suggest that the plan should be asked to bear this special expense. Again, this is a complicated situation, and Mr. Wilton must act after discussing these situations with his advisors. It is very likely that the plan does have the right to be repaid this excess payment, less taxes, from Mr. Wilton.

**Problem/Situation #7.** Thomas Newcott died in 1995, at the age of 67. He had retired in December of 1994. His 401(k) account balance as of December 31, 1994 was \$167,000. His account balance as of August 22, 1995, was \$187,000, as the stock market performed well. Prior to his death he had not yet decided if he would leave the money in the 401(k) plan and take distributions from it, or whether he would directly roll over these funds to his IRA. His wife, Monique, was his sole beneficiary. Monique has a "regular" IRA with your bank (First State Bank). The plan has sent you a check for the total amount of \$187,000.

A spouse beneficiary has the right to have a direct rollover since a spouse beneficiary, in most situations, is eligible to roll over the "inherited" funds. Many plan administrators either do not know about the \$5,000 death-benefit exclusion as set forth in Code section 101(b) or they choose to ignore it as their responsibility. Most likely the \$5,000 death-benefit exclusion would apply to this situation. This means that only \$182,000 is eligible to be rolled over. The \$5,000 amount is not eligible to be rolled over and constitutes an excess contribution and should be corrected as such. Monique Newcott needs to talk with her tax and legal advisor. **B**