THE Pension Digest

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

IRS Issues New Regulation for Direct Rollovers and Related 20% Withholding Rules

On September 22, 1995, the IRS adopted final and temporary regulations on the subjects of direct rollovers, Regulation 1.402(c)-2, and the mandatory 20% withholding upon eligible rollover distributions, Regulation 31.3405(c)-1, which are paid out from qualified plans and section 403(b) plans. These regulations are effective as of October 19, 1995, and apply to distributions made on or after October 19, 1995. Special transitional rules as discussed below may also apply.

These regulations replace the temporary regulations published on October 22, 1992. The temporary regulations apply to all distributions from January 1, 1993, to October 18, 1995, unless an individual and/or the plan administrator chooses to use the rules set forth in the final regulations.

These final regulations affect your financial institution whether you are associated with the qualified plan or are the IRA custodian/trustee which will be receiving the direct rollover from the qualified plan.

This article primarily focuses on the rules which are new or different from the earlier regulation. However, this article will restate some of the more important rules even though they have not changed.

Remember that the direct rollover option under existing law is provided in addition to the "regular" rollover rules. Thus, a participant/employee who receives an eligible rollover distribution, but who does not elect a direct rollover, still has the option to subsequently roll over the distribution to an eligible retirement plan within 60 days of receipt. Also, remember that a person may have an unlimited number of rollovers from a qualified plan since the once-per-year rule only applies to distributions from IRA plans.

What Distributions Qualify to Be Rolled Over From a Qualified Plan?

Under existing law all distributions from a qualified plan or section 403(b) plan are eligible to be rolled over except the following:

1. Any distribution to the extent the distribution is a required minimum distribution;

2. The portion of any distribution which is not includable in gross income (i.e. return of after-tax contributions, application of the $5,000 death-benefit exclusion), except net unrealized appreciation of employer securities, is included;

3. Any distribution that is one of a series of substantially equal periodic payments (not less frequently than annually) over one of the following periods:

a. A specified period of 10 years or more;

b. The life of the participant (or the joint lives of the participant and the participant's designated beneficiary;

c. The life expectancy of the participant (or the joint-life and last-survivor expectancy of the participant and the participant's designated beneficiary); and

4. Certain "corrective" distributions.

When Is There Mandatory 20% Withholding?

A distribution which is eligible to be rolled over, but which is paid to the distributee, is subject to mandatory 20% withholding. However, there is a limit which applies. The maximum amount which may be withheld is the sum of the amount of money and the fair market value of property (other than employer securities) that is received in the distribution.

The plan administrator may agree to withhold more than 20%, but is not required to withhold more than 20%.

A plan administrator need not withhold the 20% if the distributed amount is less than $200. However, all eligible rollover distributions received within one tax year must be aggregated for purposes of determining whether the $200 limit is reached. If the plan administrator does not know if there will be subsequent distributions, then the plan administrator need not withhold from the first distribution.

If the employer has more than one plan, the plan administrator may, but is not required to, aggregate the distributions from each plan. That is, the $200 limit applies to each plan.

A distribution which is not eligible to be rolled over, and which is includable in gross income, is subject to the other withholding rules which allow the recipient to elect to not have withholding.

Amending Plan Documents.

Employers will not need to amend their plans for this final regulation. That is, plans may continue to use the model amendment published in Rev. Proc. 93-12 to comply in form with section 401(a)(31) and these final regulations.

The Section 402(f) Notice Requirement

A qualified plan administrator must furnish a complying section 402(f) notice to a participant entitled to payment of his or her vested account balance no more than 90 days and no less than 30 days prior to the distribution. This regulation adopts the change made by Notice 93-26 which allows a participant who is not subject to the spousal consent rules (i.e. most participants of profit sharing plans) to affirmatively elect to make a direct rollover or receive an immediate payment. This notice must be provided directly to each distributee; it cannot be posted. There is no lessening of the 90-day requirement.

Employers are reminded that the IRS, in Notice 92-48, provided a safe harbor explanation that could be used to satisfy the section 402(f) notice requirement. The IRS is considering developing some additional model language to address some subjects not covered in the current model language. Such topics are: withholding on employer securities, treatment of plan loan offset amounts (including withholding and the timing and the availability of a right to roll over), and the $5,000 death-benefit exclusion. The "current" model language can still be used even when issues not

Continued on page 2

Also in this issue –

addressed therein would apply to the distributee. However, the IRS encourages plan administrators to change their notice to address these issues, when applicable. Please note that the CWF Form #857 already includes discussion of the $5,000 death-benefit exclusion topic.

Procedures for Direct Rollovers

A direct rollover may be accomplished by any reasonable means of direct payment to an eligible retirement plan. If payment is made by check, it must be negotiable only by the custodian/trustee of the receiving plan. If payment is made by wire transfer, it must be directed to the trustee.

The final regulation does not require any standard notation on the face of the check (such as "direct rollover"). If the receiving plan is an IRA, then the payee of the check should be, "ABC Bank as custodian/trustee of IRA of Sara Smith." Note that the bank, as custodian/trustee, must be identified by name. If the receiving plan is another QP plan, the payee line of the check need not identify the trustee by name. A generic reference is sufficient, "Trustee of the ABC profit sharing plan for the benefit of Sara Smith."

A qualified plan administrator must allow a participant to elect to have a portion of his or her account balance directly rolled over and another portion paid to him or her as long as such amount to be paid to him or her is at least $500. The plan administrator need not consent to a participant's request to have two or more distributions paid via direct rollovers to two or more eligible retirement plans. That is, the plan administrator need only make one direct rollover.

Discussion of Changes/Clarifications

With respect to the $5,000 death-benefit exclusion, the plan administrator is able to presume that it applies and that the applicable amount (the lesser of $5,000 or the amount of the distribution) is not eligible to be rolled over. If it would turn out that this amount was eligible to be rolled over because other payments qualified for the exclusion, then the recipient could use the regular rollover rules and roll over some or all of these funds.

There are three new rules with respect to required minimum distributions. The participant will like the first new rule. Participants and IRA custodians rightfully will not like the second new rule or the third new rule.

The first new rule is concerned with the problem of allocating the return of nontaxable basis in a certain situation. If part (but not all) of a payment is a required minimum amount and if part (but not all) of this payment represents a return of nontaxable basis, then the plan must first allocate the basis towards the required minimum amount and then the remaining required minimum amount will be satisfied from the portion of the distribution which will be includable in gross income. For example, assume an individual will receive a distribution of $5,000 in 1995. Of this, $1,000 is the return of his basis and $4,000 is his required minimum distribution. The allocation is as follows: (1) $1,000 is allocated as a required minimum amount; (2) $3,000 of the taxable portion is also allocated to the required minimum and is not eligible to be rolled over and
(3) the remaining $1,000 of the taxable portion is eligible to be rolled over, and thus qualifies to be directly rolled over.

The second new rule is that the plan administrator, for purposes of calculating the RMD for any calendar year, is permitted to assume that there is no designated beneficiary. These are the effects of this new rule:

1. Even though a QP participant for RMD purposes is entitled to use a joint life-expectancy factor, the plan administrator may calculate his or her RMD based upon a single life expectancy.

2. Thus, the plan administrator may pay out more than the minimum. If the participant wishes (and if he or she knows), he or she will qualify to roll over the amount equal to the difference between the "joint" minimum and the "single"calculation.

This rules shows that if someone "yells" to the IRS hard enough, the IRS may adopt their position even though it is not the best one. Why shouldn't the plan administrator determine what the RMD is, since it has, or can easily obtain, all of the information needed to make the RMD calculation!

In effect, the IRS, in this direct rollover regulation has amended the position it took in the proposed regulation dealing with required minimum distributions.

The third new rule is concerned with the application of the rollover rules for a beneficiary of a participant who has been receiving a series of distributions or an annuity payout and such payments were not eligible to be rolled over. The beneficiary will either be a surviving spouse or a person other than the spouse (i.e. a non-spouse).

The rule for a spouse beneficiary is that the rollover rules of section 402(c) will apply to the continuing distributions to the spouse in the same manner as if the spouse was the participant. This is a complicated way of saying — if the participant could have rolled over this distribution, then as the surviving spouse will be entitled to roll it over; and if the participant could <u>not</u> have rolled over this distribution, then the surviving spouse will not be entitled to roll it over. It does not matter that the payment period remaining after the death of the participant is or may be less than the period described in section 402(c)(4)(A). The IRS gave the following example, "substantially equal periodic payments made under a life annuity with a five-year term certain would not be an eligible rollover distribution even when paid after the death of the employee with three years remaining under the term certain."

The actual regulation reads as follows:

"Q-12: How does section 402(c) apply to a distributee who is not the employee?

A-12: (a) Spousal distributee. If any distribution attributable to an employee is paid to the employee's surviving spouse, section 402(c) applies to the distribution in the same manner <u>as if the spouse were the employee</u>. The same rule applies if any distribution attributable to an employee is paid in accordance with a qualified domestic relations order (as defined in section 414(p)) to the employee's spouse or former spouse who is an alternate payee. Therefore, a distribution to the surviving spouse of an employee (or to a spouse or former spouse who is an alternate payee under a qualified domestic relations order), including a distribution of ancillary death benefits attributable to the employee, <u>is an eligible rollover distribution if it meets the requirements of section 402(c)(2) and (4) and Q&A-3 through Q&A-10 and Q&A-14 of this section</u>. However, a qualified plan (as defined in Q&A-2 of this section) is not treated as an eligible retirement plan with respect to a surviving spouse. Only an individual retirement plan is treated as an eligible retirement plan with respect to an eligible rollover distribution to a surviving spouse.

(b) Nonspousal distributee. A distributee other than the employee or the employee's surviving spouse (or a spouse or former spouse who is an alternate payee under a qualified domestic relations order) is not permitted to roll over distributions from a qualified plan. Therefore, those distributions do not constitute eligible rollover distributions under section 402(c)(4) and are not subject to the 20 percent income tax withholding under section 3405(c)."

This new rule will certainly apply to annuities and prevent surviving spouses from rolling over the surrender amount. It is not totally clear if it will apply to QP plans established with banks, savings and loans or credit unions. However, one can expect that if the original term is set up for 10 years or more, then the IRS will conclude that a surviving spouse will not be eligible to roll over such funds.

If a person wishes to receive a payout from his or her one-person qualified plan or any other qualified plan which exceeds his or her required amount, he or she may wish to make sure this excess will be paid out over a period of less than 10 years if he or she wishes to reserve for the spouse the right to roll over the remaining balance to an IRA after his or her death.

Governmental Reporting Topics

When there is withholding, the plan administrator has the responsibility to maintain the records and prepare the required reports. However, if the plan administrator fails to do so, it is the employer who is ultimately responsible.

Continued on page 3

IRS Issues—*Continued from page 2*

A Form 1099-R must be prepared for each eligible rollover distribution just as one needs to be prepared for any "real" distribution. The instructions for the completion of Form 1099-R must be followed.

If the funds are directly rolled over into an IRA, then the IRA custodian/trustee must report this as a rollover in box 2 of Form 5498.

If the funds are directly rolled over into another qualified plan or 403(b), the recipient plan is not required to report the receipt of the direct rollover or any other rollover.

Special Transition Rules

The IRS will not penalize the plan during the period of October 19, 1995, to December 31, 1995, for failing to comply with the new regulations if there is compliance with the temporary regulations.

The IRS will also allow a distributee to roll over a distribution during the period of October 19, 1995, to December 31, 1995, even though such distribution is not eligible to be rolled over under the new regulations as long as the distribution was eligible to be rolled over under the temporary regulations.

The plan administrator and the distributee may each make his or her own election whether to use the final regulation or the temporary regulation.

Summary

The IRS has finalized its regulation on direct rollovers and the mandatory withholding of 20% for distributions which are eligible to be rolled over, but which are paid directly to the participant. This article has been a summary of the new regulations. There will be situations where you will need to refer to the regulations themselves. PD

The Pension Digest

Capital Ratios and Pass-Through Insurance Rules

The March and July newsletters discussed the requirement of insured banks and savings and loans to furnish notices to the trustee of an employee benefit plan concerning the availability of pass-through insurance coverage with respect to a plan deposit.

In order to furnish the required FDIC pass-through notices, an insured institution must calculate various capital ratios.

The purpose of this article is to present a limited discussion of how these ratios are calculated. As you already know, or will soon observe, the calculation of these ratios is complex. Your institution will have someone who performs these calculations. You should determine who this person is so he or she can provide you with these ratios. In general, the starting point for these calculations is a "Reports of Condition and Income" (Call Report). However, there is very specific financial data which is needed to calculate these ratios which is not included within the Call Report, but which is known by the person making the calculations.

The purpose of this article is not to set forth again a complete discussion of the pass-through notice rules. You should refer to prior articles for this information.

To simplify the discussion of these ratios, the article is written under the assumption that your financial institution is a bank.

When a new account is established, you must furnish your institution's current corrective action capital category — well capitalized; adequately capitalized; undercapitalized, significantly undercapitalized or critically undercapitalized.

When a trustee requests the FDIC pass-through notice, you must furnish all of the following capital ratios:

1. Leverage ratio;
2. Tier 1 Risk-Based Capital Ratio;
3. Total Risk-Based Capital Ratio; and
4. PCA (Prompt Corrective Action) Capital Category.

How Are These Three Ratios Determined?

The FDIC has issued Part 325 of Title 12, Code of Federal Regulations. There are three parts to this regulation. The first part sets forth when and why the FDIC will evaluate an insured depository institution's capital structure (e.g. review of applications, determining whether or not an institution is safe and sound, etc.). The second part, which is Appendix A, sets forth the FDIC's risked-based policy statement. The third part, which is Appendix B, sets forth an additional statement on policy of capital adequacy which provides some interpretational and definitional guidance as to how this part 325 regulation will be administered and enforced by the FDIC.

Ratio #1 – Leverage Ratio

Leverage ratio means the ratio of Tier 1 capital to total assets.

Tier 1 capital is defined by Appendix A as consisting of:

"— Common stockholders' equity capital (includes common stock and related surplus, undivided profits, disclosed capital reserves that represent a segregation of undivided profits, and foreign currency translation adjustments; less net unrealized holding losses on available-for-sale equity securities with readily determinable fair values):

— Noncumulative perpetual preferred stock, including any related surplus; and

— Minority interests in the equity capital accounts of consolidated subsidiaries.

At least 50 percent of the qualifying total capital base should consist of Tier 1 capital. *(Core (Tier 1) capital* is defined as the sum of core capital elements minus all intangible assets other than mortgage servicing rights and purchased credit card relationships, and minus any disallowed deferred tax assets.

Although nonvoting common stock, noncumulative perpetual preferred stock, and minority interests in the equity capital accounts of consolidated subsidiaries are normally included in Tier 1 capital, voting common stockholders' equity generally will be expected to be the dominant form of Tier 1 capital. Thus, banks should avoid undue reliance on nonvoting equity, preferred stock and minority interests.

Although minority interests in consolidated subsidiaries are generally included in regulatory capital, exceptions to this general rule will be made if the minority interests fail to provide meaningful capital support to the consolidated bank."

Total assets are defined as follows:

"(v) *Total assets* means the average of total assets required to be included in a banking institution's "Reports of Condition and Income" (Call Report) or, for savings associations, the consolidated total assets required to be included in the "Thrift Financial Report," as these reports may from time to time be revised, as of the most recent report date (and after making any necessary subsidiary adjustments for state nonmember banks as described in 325.5(c) and 325.5(d) of this part), minus intangible assets (other than mortgage servicing rights and purchased credit card relationships eligible for inclusion in core capital pursuant to § 325.5(f) and qualifying supervisory goodwill eligible for inclusion in core capital pursuant to 12 CFR part 567), minus deferred tax assets in excess of the limit set forth in § 325.5(g), and minus assets classified loss and any other assets that are deducted in determining Tier 1 capital. For banking institutions, the average of total assets is found in the Call Report schedule of quarterly averages. For savings associations, the consolidated total assets figure is found in Schedule CSC of the Thrift Financial Report."

Ratio #2 – Tier 1 Risk-Based Capital Ratio

Tier 1 risk-based capital ratio means the ratio of Tier 1 capital to risk-weighted assets.

Tier 1 capital was defined above.

Risk-weighted assets means total risk-weighted assets. The general procedure for computing risk-weighted assets is to assign a bank's balance sheet assets and certain off balance sheets items to one of four broad risk categories — zero percent risk weight; 20 percent risk weight; 50 percent risk weight; and 100 percent risk weight. The risk-weighted assets total is the sum of all assets as adjusted or discounted by the applicable risk percentage. You will need

Continued on page 4

Capital Ratios—*Continued from page 3*

to refer to Appendix A to learn what assets fall within what risk category.

Ratio #3 – Total Risk-Based Capital Ratio

Total risk-based capital ratio means the ratio of qualifying total capital to risk-weighted assets.

Risk-weighted assets were discussed above.

Qualifying total capital is the sum of Tier 1 capital and Tier 2 capital as reduced by certain deductions.

In general, Tier 2 capital is supplementary capital and is explained in Appendix A as consisting of:

" — Allowances for loan and lease losses, up to a maximum of 1.25 percent of risk-weighted assets; — Cumulative perpetual preferred stock, long-term preferred stock (original maturity of at least 20 years) and any related surplus;

— Perpetual preferred stock (and any related surplus) where the dividend is reset periodically based, in whole or part, on the bank's current credit standing, regardless of whether the dividends are cumulative or noncumulative;

— Hybrid capital instruments, including mandatory convertible debt securities; and

— Term subordinated debt and intermediate-term preferred stock (original average maturity of five years or more) and any related surplus.

The definition of supplementary capital does *not* include revaluations reserves or hidden reserves that represent unrealized appreciation on assets such as bank premises and equity securities. Although such reserves will not be explicitly recognized when calculating a bank's risk-based capital ratio, these reserves may be taken into account as additional factors when assessing a bank's overall capital adequacy.

The maximum amount of Tier 2 capital that may be recognized for risk-based capital purposes is limited to 100 percent of Tier 1 capital (after any deductions for disallowed intangibles). In addition, the combined amount of term subordinated debt and intermediate-term preferred stock that may be treated as part of Tier 2 capital for risk-based capital purposes is limited to 50 percent of Tier 1 capital. Amounts in excess of these limits may be issued but are not included in the calculation of the risk-based capital ratio."

Various Capital Categories

The above three ratios are important because they are measures of a bank's capital and determine the capital category that applies to a bank. Set forth below is the regulation's definition of the various capital categories:

"(1) *Well capitalized* if the bank:

(i) Has a total risk-based capital ratio of 10.0 percent or greater; and

(ii) Has a Tier 1 risk-based capital ratio of 6.0 percent or greater; and

(iii) Has a leverage ratio of 5.0 percent or greater; and

(iv) Is not subject to any written agreement, order, capital directive, or prompt corrective action direction issued by the FDIC pursuant to section 8 of the FDI Act (12 U.S.C. 1818), the International Lending Supervision Act of 1983 (12 U.S.C. 3907), or section 38 of the FDI Act (12 U.S.C. 1831o), or any regulation thereunder to meet and maintain a specific capital level for any capital measure.

(2) *Adequately capitalized* if the bank:

(i) Has a total risk-based capital ratio of 8.0 percent or greater; and

(ii) Has a Tier 1 risk-based capital ratio of 4.0 percent or greater; and

(iii) Has:

(A) A leverage ratio 4.0 percent or greater; or

(B) A leverage ratio of 3.0 percent or greater if the bank is rated composite 1 under the CAMEL rating system in the most recent examination of the bank and is not experiencing or anticipating significant growth; and

(iv) Does not meet the definition of a *well capitalized* bank.

(3) *Undercapitalized* if the bank;

(i) Has a total risk-based capital ratio that is less 8.0 percent; or

(ii) Has a Tier 1 risk-based capital ratio of 4.0 percent or greater; and

(iii) (A) Except as provided in paragraph (b)(3)(iii)(B) of this section, has a leverage ratio that is less than 4.0 percent; or

(B) Has a leverage ratio that is less than 3.0 percent if the bank is rated composite 1 under the CAMEL rating system in the most recent examination of the bank and is not experiencing or anticipating significant growth.

(4) *Significantly undercapitalized* if the bank has:

(i) A total risk-based capital ratio that is less than 6.0 percent; or

(ii) A Tier 1 risk-based capital ratio that is less than 3.0 percent; or

(iii) A leverage ratio that is less than 3.0 percent.

(5) *Critically undercapitalized* if the insured depository institution has a ratio of tangible equity to total assets that is equal to or less than 2.0 percent."

Conclusion

The calculation of these ratios is complex, but in order for your institution to comply with the FDIC pass-through notice rules, someone at your institution must be able to calculate these ratios. He or she will need to refer to FDIC regulation 325. Be aware that the Comptroller of the Currency and some independent vendors have developed software to assist with the calculation of these ratios. PD

The Pension Digest

$5,000 Death-Benefit Exclusion

Internal Revenue Code section 101(b) authorizes a $5,000 exclusion from the gross income of a recipient for the payment of certain death benefits.

Distributions from qualified plans (section 401(a)) and section 403(b) may qualify for this $5,000 exclusion, but a distribution from an IRA or SEP-IRA never qualifies for this exclusion.

The concept of the law originally was – when a death occurs it is a time of hardship; if an employer makes a payment to the family of the deceased employee of monies it otherwise did not owe, then the person who is paid this "gift" should receive a special tax treatment and should not have to pay tax on the first $5,000 of such payments.

Note that this payment of money need not come from a pension plan. It can come just from the general assets of the employer. Also note that any money which the employer owed the decedent at the time of death (salary, accrued vacation, etc.) does not qualify for the $5,000 exclusion.

The original law was changed (i.e. expanded) to provide that certain payments from a pension plan would qualify for the $5,000 exclusion.

If the decedent was vested in his or her pension account balance at the time of death, then in order to qualify for the exclusion, there must be a "lump-sum distribution" from the pension plan. Code section 402(e) must be read to determine the rules which must be met to have a lump-sum distribution.

If the decedent was not vested in his or her account balance at the time of death, then the amount may be paid in any format (i.e. does not need to be a lump-sum distribution).

The $5,000 exclusion is per decedent and not per employer or per beneficiary. Thus, if there are multiple beneficiaries and/or multiple employers, the $5,000 exclusion must be prorated between the beneficiaries.

The IRS in a regulation which they issued as of September 22, 1995, has said that the QP plan, or the section 403(b) annuity, can assume that the $5,000 exclusion will come fully from their plan even though it may not. The ultimate tax determination responsibility falls on the "recipient." This means the QP administrator can assume that the first $5,000 of any distribution is not eligible to be rolled over. PD