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UPDATED IRS FORMS

Form 1099-R

The IRS has recently issued the 1996 Form 1099-R. A copy is set forth. There are no changes to the form except for the change in the year from 1995 to 1996.

The IRS has added additional explanatory paragraphs in the instruction section. This article summarizes those additional explanations and hopefully will help you start planning for preparing the 1996 Form 1099-R. The Form 1099-R is used to report distributions from qualified plans, IRAs and insurance annuities. This article discusses the new explanations which apply to qualified plans and IRAs. The majority of the new provisions apply to qualified plans and not IRAs.

The most valuable portion of the "new" instructions is a summary of the reporting which is required for corrective distributions from 401(k), 403(b) and SAR-SEP plans. In the past, the instructions had simply referenced some IRS Notices issued in 1987-1991, and these notices were confusing at best. The summary presented in the instructions is very good and is set forth at the end of this article.

As with the Form 5498, there is now the explanation stating that an IRA includes all investments under one IRA plan agreement. Only one Form 1099-R is to be filed for any one or more distributions from an IRA, even if the distributed funds come from different investments, as long as the same distribution code applies. The rule is unchanged which states that multiple Form 1099-Rs must be prepared if different reason codes apply to distributions.

Who Must be Furnished the Form 1099-R?

The general statement that a payer must file a Form 1099-R for each person to whom it made a designated distribution is unchanged. A statement has been added saying that a distribution to an alternate payee who is a spouse or former spouse of the employee under a qualified domestic relations order (QDRO) is reportable on the Form 1099-R using the name and TIN of the alternate payee. This statement is not as correct as it could be, since an alternate payee under a divorce decree could be a child in addition to being a spouse. The instructions also contain a provision which states that a transfer of an interest in an IRA from one spouse to another spouse under a divorce or separation agreement is tax free, and a Form 1099-R is not to be prepared.

Changes With Respect to Direct Rollovers/Withholding

Some people continue to mistakenly believe that the mandatory 20% withholding rule applies to IRA distributions just as it does to distributions from qualified plans and section 403(b) annuities. The instructions make it very clear that 20% withholding does not apply to distributions from IRAs.

The instructions finally address one of the most frequently asked consulting questions, "Do we, the IRA custodian, have to collect the 10% excise tax because the IRA recipient is taking a distribution and is not yet 59 1/2?" The statement is made that you are not required to withhold this tax. An additional explanation is probably needed stating that the general withholding rules apply and that the recipient could instruct you to withhold more than 10%, and this additional amount would cover the 10% excise tax.

The instructions make clear that although a direct rollover will normally be made on the behalf of a participant of a qualified plan or section 403(b) annuity, a direct rollover may be made for the employee's surviving spouse, or for a spouse or former spouse who is an alternate payee under a qualified domestic

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Form 5305A-SEP

In March of 1994 the IRS issued an updated version of the Form 5305A-SEP, Salary Reduction and Other Elective Simplified Employer Pension – Individual Retirement Accounts Contribution Agreement. This version stated it would expire on March 31, 1996.

An employer who properly adopts a Form 5305A-SEP will have established a SAR-SEP which allows its eligible employees to make elective deferrals as authorized by Internal Revenue Code section 408(k)(6). A SAR-SEP is very similar to a 401(k) plan in that an eligible employee can defer a portion of his or her payroll or bonus into a retirement plan which receives special tax benefits. In general, an eligible employee on an annual calendar year basis can defer the lesser of 15% of his or her compensation or $9,500.00.

March 31, 1996, came and went and the IRS had not yet issued the new version. The IRS has recently issued the new form two to three weeks late. The new version

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relations order (QDRO). A direct rollover for a surviving spouse may only be made to an IRA. It appears that a direct rollover because of a QDRO may go to another QP or 403(b) plan when the deemed recipient is a spouse or former spouse.

The instructions discuss the requirements of a plan administrator to furnish the section 402(f) notice. A paragraph has been added covering the notice requirement when a recipient is receiving periodic distributions which are eligible rollover distributions (i.e. a series for less than 10 years). The payer (i.e. the plan administrator) must furnish the notice before the first payment and at least once a year as long as the payments continue.

Discussion of Distribution Codes

The instructions indicate that there are now three situations where the use of two numeric codes on one Form 1099-R is permitted. These are Codes 8 and 1, Codes 8 and 2, and Codes 8 and 4. The new one is Codes 8 and 4. If two other numeric codes apply to a distribution, then a Form 1099-R must be prepared for each type of distribution code.

The instructions now emphasize that a Code 1 will need to be used in the following situation. "Even if the employee/taxpayer is 59 1/2 or over, use Code 1 if a series of substantially equal periodic payments was modified within 5 years of the date the first payment (within the meaning of section 72(q)(3) or (t)(4)). For example, Mr. B began payments that qualified for the exception for part of a series of substantially equal periodic payments under section 72(t)(2)(A)(iv) when he was 57. When he was 61, Mr. B substantially modified the payments. Because the payments were modified within 5 years, use Code 1 in the year the payments were modified even though Mr. B is over 59 1/2."

With respect to the withdrawal of an excess contribution after the due date of the individual's return under Code section 408(d)(5), the instructions now read, "... enter 0 (zero) in box 2(a). You might use Code 1 or 7 in box 7 depending on the age of the participant." The IRS has never given good guidance as to what code should be used for the withdrawal of an excess contribution after the due date. The use of the word "might" does not imply that a payer must use these codes. However, the description for code "8" is now limited to being used for distributions before the due date of the return. At one time the IRS instructions clearly indicated that the "8" was used to report both types of excess contributions — those withdrawn before the due date and those withdrawn after the due date. The IRS has now given the indication they prefer the use of Code 1 or 7 when an excess is withdrawn after the due date. A zero is still reported in box 2a (taxable amount), if applicable and if known.

Corrective Distributions

The IRS added the following to the 1996 Form 1099-R instructions. This is an excellent summary of the reporting rules which must be complied with when there has been a corrective distribution of an excess deferral, excess contribution or excess aggregate contribution. There rules are not simple, but it is now much easier to understand them because of the IRS' summary.

Corrective Distributions.—You must report on Form 1099-R corrective distributions of excess deferrals, excess contributions and excess aggregate contributions under section 401(a) plans, Section 401(k) cash or deferred arrangements, section 403(a) annuity plans, section 403(b) salary reduction agreements, and salary reduction simplified employee pensions (SARSEPs under section 408(k)(6)). Corrective distributions of an excess plus earnings are reportable on Form 1099-R for the year of the distribution regardless of when the distribution is taxable to the participant. Distribution Code 8, P, or in some cases, D is entered in box 7 to designate the distribution and the year it is taxable.

If the excess and the earnings are taxable in two different years, you must issue two Forms 1099-R to designate the year each is taxable.

You must advise the plan participant at the time of the distribution of the year or years in which the distribution is taxable and that it may be necessary to file an amended return for a prior tax year.

For more information about reporting corrective distributions, see below; Codes 8, P, and D later; Notice 89-32, 1989-1 C.B. 671; Notice 88-33, 1988-1 C.B. 513; Notice 87-77, 1987-2 C.B. 385; Rev. proc. 91-44, 1991-2 C.B. 733 (SARSEPs); and the regulations under sections 401(k) and 401(m).

Excess deferrals.—Excess deferrals under section 402(g) can occur in 401(k) plans, 403(b) plans, or SARSEPs. If distributed by April 15 of the year following the year of deferral, the excess is taxable to the participant in the year of deferral, but the earnings are taxable in the year distributed. Except for a SARSEP, if the distribution occurs after April 15, both the excess and earnings are taxable in the year of deferral AND the year distributed. For a SARSEP, excess deferrals not withdrawn by April 15 are considered regular IRA contributions subject to IRA contribution limits. Corrective distributions of excess deferrals are not subject to Federal income tax withholding or social security or Medicare taxes. For losses on excess deferrals, see ***Losses*** below.

Excess contributions.—Excess contributions can occur in a 401(k) plan or a SARSEP. For a 401(k) plan, if the withdrawal of the excess plus earnings occurs within 2 1/2 months after the close of the plan year, the excess and earnings are taxable to the participant in the year deferred. But if the corrective distribution is made after the 2 1/2-month period, or the excess contribution (not including earnings) (and excess aggregate contributions in the case of a 401(k) plan) is less than $100 (de minimis rule), the excess and earnings are taxable in the year distributed. For recharacterized excess contributions, the excess is taxable in the year a corrective distribution would have occurred. (No income is allocated to recharacterized amounts.) For a SARSEP, you must notify the participant by April 15 of the year after the year the excess contribution was made that the participant must withdraw the excess and earnings. The excess contribution is taxable to the participant in the year of deferral and the earnings are taxable in the year withdrawn. If the excess contribution (not including earnings) is less than $100; the excess is taxable in the year of notification and the earnings are taxable in the year withdrawn. An excess contribution not withdrawn by April 15 of the year after the year of notification is considered a regular IRA contribution subject to the IRA contribution limits. Excess contributions distributed within the 2 1/2-month period are not subject to Federal income tax withholding or social security or Medicare taxes. But amounts distributed from a 401(k) plan after the 2 1/2-month period are subject to Federal income tax withholding under section 3405.

Excess aggregate contributions.—Excess aggregate contributions under section 401(m) can occur in 401(a), 401(k), 403(a), and 403(b) plans. A corrective distribution of excess aggregate contributions plus earnings within 2 1/2 months after the close of the plan year is taxable to the participant in the year the contributions were made. A corrective distribution made after the 2 1/2-month period is tax-

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9898 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code		1 Gross distribution $ 2a Taxable amount $	OMB No. 1545-0119 1996 Form 1099-R	**Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.**
		2b Taxable amount not determined ☐	Total distribution ☐	**Copy A For Internal Revenue Service Center**
PAYER'S Federal identification number	RECIPIENT'S identification number	3 Capital gain (included in box 2a) $	4 Federal income tax withheld $	**File with Form 1096.**
RECIPIENT'S name		5 Employee contributions or insurance premiums $	6 Net unrealized appreciation in employer's securities $	For Paperwork Reduction Act Notice and instructions for completing this form, see **Instructions for Forms 1099, 1098, 5498, and W-2G.**
Street address (including apt. no.)		7 Distribution code / IRA/SEP ☐	8 Other $ %	
City, state, and ZIP code		9a Your percentage of total distribution %	9b Total employee contributions $	
Account number (optional)		10 State tax withheld $ $	11 State/Payer's state no.	12 State distribution $ $
		13 Local tax withheld $ $	14 Name of locality	15 Local distribution $ $

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able in the year distributed. Report the gross distribution in box 1 of Form 1099-R. In box 2a, enter the excess and earnings distributed less any after-tax contributions. If the total excess contributions and excess aggregate contributions distributed are less than $100 (excluding income), the distribution is taxable in the year of distribution made within 2 1/2 months after the close of the plan year is not subject to Federal income tax withholding or social security or Medicare taxes. But amounts distributed after 2 1/2 months are subject to Federal income tax withholding under section 3405.

Losses.—If a corrective distribution of an excess deferral is made in a year after the year of deferral and a net loss has been allocated to the excess deferral, report the corrective distribution amount in boxes 1 and 2a of Form 1099-R for the year of the distribution with the appropriate distribution code in box 7. However, taxpayers must include the total amount of the excess deferral (unadjusted for loss) in income in the year of deferral, and they may report a loss on the tax return for the year the corrective distribution is made. Therefore, provide the taxpayer with a separate statement that the excess deferral, unadjusted for loss, must be reported on the wages line of the tax return for the year of the deferral and that the loss may be reported as a bracketed amount on the "Other income" line of the tax return for the year of the corrective distribution.

Excess Annual Additions Under Section 415.—You must report on Form 1099-R distributions made under Regulations section 1.415-6(b)(6)(iv) of elective deferrals or a return of employee contributions (and gains attributable to such employee contributions) to reduce excess annual additions arising from the allocation of forfeitures, a reasonable error in estimating a participant's compensation, or a reasonable error in determining the amount of elective deferrals that may be made for an individual under the limits of section 415.

Such distributions are not eligible rollover distributions although they are subject to income tax withholding under section 3405. They are not subject to social security, Medicare, or Federal Unemployment Tax Act (FUTA) taxes. In addition, such distributions are not subject to the early distribution tax under section 72(t) nor the excess distributions tax under section 4980A.

You may report the distribution of elective deferrals and employee contributions (and gains attributable to such elective deferrals and employee contributions) on the same Form 1099-R. However, if other distributions are made during the year, they must be reported on a separate Form 1099-R. Because the distribution of elective deferrals is fully taxable (no part of the distribution is a return of the investment in the contract), report the total amount of the distribution in boxes 1 and 2a. Leave box 5 blank, and enter Code E in box 7. For a return of employee contributions plus gains, enter the gross distribution in box 1, the gains attributable to the employee contributions being returned in box 2a, and the employee contributions being returned in box 5. Enter Code E in box 7.

For more information, see Rev. Proc. 92-93, 1992-2 C.B. 505.

Failing the ADP or ACP Test After a Total Distribution.—If you make a total distribution in 1996 and file a Form 1099-R with the IRS and then discover in 1997 that the plan failed either the section 401(k)(3) ADP (actual deferral percentage) test for 1996 and you compute excess contributions or the section 401(m)(2) ACP (actual contribution percentage) test and you compute excess aggregate contributions, you must recharacterize part of the total distribution as excess contributions or excess aggregate contributions. First, file a CORRECTED Form 1099-R for 1996 for the correct amount of the total distribution (not including the amount recharacterized as excess contributions or excess aggregate contributions). Second, file a NEW Form 1099-R for 1996 for the excess contributions and allocable earnings.

To avoid a late filing penalty if the new Form 1099-R is filed after the due date, enter in the bottom margin of Form 1096 the words "Filed to Correct Excess Contributions."

You should also issue copies of the Forms 1099-R to the plan participant with an explanation of why these new forms are being issued.

Does a Series of Payments for 10 Years or Longer Qualify as Substantially Equal Periodic Payments?

Many times the same term or concept is used within the Internal Revenue Code.

You are most familiar with the term, or concept, "substantially equal periodic payment" because of Internal Revenue Code section 72(t)(2)(iv). The additional 10% tax does not apply to a distribution from a qualified plan or an IRA which is "part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employer or the joint lives (or joint life expectancy) of such employee and his designated beneficiary." The IRS, in Notice 89-25, set forth three safe harbors – distribution formulas which, if used, would be found to be substantially equal for purposes of Code section 72(t). Each of the three methods require the distribution amount to be determined using the anticipated life expectancy of the participant, or joint life expectancy.

The "substantially equal periodic payment" term, however, is also important because it is used in Code section 402(c). Code section 402(c)(4) defines what is an eligible rollover distribution from a qualified plan. In general, all distributions are eligible to be rolled over except a distribution which is one of a series of substantially equal periodic payments made for the life/joint life (expectancy) of the employee, or for a specified period of 10 years or more. However, RMD distributions are not eligible to be rolled over.

Note that for purposes of Code section 402(c) (i.e. determining if a distribution is eligible to be rolled over) the statute gives two options – a series of distributions over a person's life, or over 10 years or more. Under the rollover rules, it is clear that the series of payments only needs to be for 10 years or longer. It may be longer, but it need not be.

The purpose of this article is to point out that this option or concept of 10 years does not exist under Code section 72(t)(2)(A)(iv). Thus, a series of distributions for 11 years would not qualify to be rolled over (and thus would not be subject to the mandatory 20% withholding rule), but each distribution would still be subject to the 10% excise tax.

Question & Answer #5 of the regulations states that "For purposes of determining whether a distribution is an eligible rollover distribution, how is it determined whether a series of payments is a series of substantially equal periodic payments over a period specified in section 402(c)(4)(A)?" The general rule is that the principles of section 72(t)(2)(A)(iv) are to be used. And paragraph (d) of A-5 states that the following rules are to be used to determine whether a series of payments from a defined contribution plan qualify as substantially equal periodic payments for purposes of section 402(c)(4)(A).

The first rule is that the declining balance of years method may be used. Under this method the amount of the distribution is calculated by dividing the account balance by the number of years remaining in the period. The calculation, of course, must start with the divisor being 10 or more.

The second rule is that a flat annual distribution will qualify as a series of substantially equal periodic payments as long as reasonable actuarial assumptions would show that the distribution schedule will last for 10 years or more.

Summary

The rules which the IRS set forth for purposes of determining whether a series of distributions from a qualified plan qualify to be rolled are similar, but are different from the rules which apply for purposes of determining whether this same series of distributions will be exempt from the 10% excise tax imposed by section 72(t).

For example, a QP participant, age 54, with a life expectancy of 29.5 years would owe the 10% excise tax if she set up a series of distributions over 11 years (or over any period less than 29.5 years). This series of distributions would not qualify as an eligible rollover distribution and thus the 20% withholding rule would not apply.

Similarly, an IRA owner, age 54, with a life expectancy of 29.5 years would owe the 10% excise tax if she set up a series of distributions over 10 years (or over any period less than 29.5 years).

Status of Legislation

On March 28, 1996, the House passed a health insurance reform bill. On April 18, 1996, the Senate passed its version of health insurance reform legislation. These separate bills will now go to the Conference Committee.

The House bill contains authority for medical savings accounts (MSAs). The Senate bill does not. In general, MSAs would be a special type of IRA account. The January newsletter summarized MSAs. Vice President Gore has stated that President Clinton will veto any health insurance reform law which includes MSAs. The concern appears to be that those people who are healthy, or perceive themselves as healthy, will purchase health insurance with a high deductible and then use their MSAs to cover their regular health expenses. President Clinton contends that the decision by healthy people to not purchase regular policies (low deductibles) will most likely result in the premiums for such policies to increase substantially, thus making such policies too expensive and unavailable to many people.

There are a number of proposed IRA law changes contained within the Senate's health insurance bill. These changes do "relate" to the health reform bills.

First, a person withdrawing funds from his or her IRA or 401(k) plan to pay for long-term care insurance would not pay the 10% excise tax, but would pay income tax on the amount withdrawn.

Second, a person withdrawing funds from his or her IRA in order to pay health insurance premiums would not be subject to the 10% excise tax as long as the person had received unemployment compensation for at least 12 weeks. The person would pay income tax on the amount received.

Third, a person withdrawing funds from his or her IRA in order to pay catastrophic medical expenses (i.e. those in excess of 7.5% of adjusted gross income) would not pay tax on the amount withdrawn.

President Clinton has again stated that he would like to see a bill passed this year covering pension and IRA changes. Time will tell.

Error With Respect to Conduit IRA – NOT Correctible

Tax errors can happen for numerous reasons. A financial institution which serves as an IRA custodian/trustee or renders services to qualified plans must be aware that many mistakes are not correctable. Sometimes it is the individual who makes the error, sometimes it is your financial institution, and sometimes it is the accountant or attorney. The party or parties responsible for the error will have to accept responsibility and pay for the harm they have caused.

The Factual Situation of the Letter Ruling

A husband and wife were working with a broker-dealer. They had both recently retired from service from their respective employers and wanted to roll over their vested account balances from the respective plans in which they had been participants, to a new profit sharing plan which they had established with respect to a new business. They had intended to borrow from the new plan so that they could invest in one or more fast-food franchises. Such a borrowing cannot generally be done with respect to an IRA, but is permissible, within limits, from a corporate-sponsored qualified plan.

The husband's vested account balance was rolled over correctly into the new profit sharing plan.

The wife's vested account balance was not rolled over correctly. The funds which came to the broker/dealer were mistakenly put into her existing IRA account. That is, the QP funds were commingled within the IRA with non-rollover funds.

The broker/dealer suggested to the woman that she write the IRS explaining the situation and asking for a ruling stating that she would be eligible to take a distribution from the IRA and roll over these funds into the new profit sharing plan. The broker/dealer wanted the IRS to undo the broker/dealer's error. She wrote the IRS, but she did not receive the hoped-for response.

The IRS ruled that the IRA was not a "conduit" IRA as defined in Code section 408(d)(3)(a)(ii) because there were assets within the IRA that were attributable to a source other than a rollover contribution from an employee's trust described in section 401(a) which is exempt for tax under section 501(a). Any attempt to now transfer or roll over the funds from the IRA into the profit sharing plan would be a taxable distribution. If there was such a rollover or transfer into the profit sharing plan, the profit sharing plan would face disqualification.

There is no doubt that she was harmed by the broker/dealer's error. She and the broker/dealer will need to determine the extent of her financial harm.

Point of the Article

A financial institution must have well-established procedures to handle the receipt of rollover, direct rollover and transfer contributions. The financial consequences to a financial institution can be quite harsh if the funds are placed in the "wrong" account. For example, funds which should have gone into an IRA account are mistakenly put into a checking account. A taxable distribution has occurred and must be reported on the Form 1099-R, or the penalties for not reporting the Form 1099-R will apply. You must have well-established procedures or your institution may end up having to compensate a customer for the tax problems which your personnel caused.

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shows a revision date of April 1996. This version of 5305A-SEP contains no expiration date.

When Must the New Form be Used?

An employer who used the March 1994 version of 5305A-SEP to establish or amend a SEP prior to May 1996 is not required to use the April 1996 version. That is, existing plans do not need to be amended.We would surmise the reason is that the changes to the form have been very minimal. In general, the main changes were to replace the various indexed amounts which applied for 1994 and 1995 ($396, $9,240, and $99,000) by the amounts which apply for 1996 ($400, $9,500 and $100,000).

Since a sponsoring employer will not need to sign the April 1996 version of Form 5305A-SEP if it established its plan prior to May of 1996, then your financial institution, which serves as the IRA custodian/trustee will not need to obtain the April 1996 version for your files.

The new form will need to be used for new SAR-SEP plans established in May of 1996 or later. An order form is enclosed for your convenience.