THE Pension Digest

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Status of IRA Legislation

There is not really that much new to report. As you know, the Republicans and the Democrats are playing their political games.

On April 11, 1996, President Clinton presented The Retirement Savings and Security Act. His proposal contains numerous provisions to expand IRAs including the creation of a new type of employer-sponsored retirement plan - the National Employee Savings Trust (NEST). The NEST is a combination of a 401(k) plan and an IRA. The President's proposals are essentially the same as he has previously proposed and will not be repeated in this newsletter. They have been discussed in earlier newsletters.

The House of Representatives, under Republican leadership, has passed a set of small business tax incentives. The only changes that relate to IRAs, within this proposed bill, are to the SIMPLE plan. See the December, 1995, issue of *The Pension Digest* for a discussion of the SIMPLE plan. An employer could either design the SIMPLE to use IRAs for each participant or as a part of a 401 (k) plan. There are numerous changes proposed with respect to qualified plans. This bill would repeal salary-reduction SEP plans unless the SAR-SEP was established prior to January 1, 1997. Note that regular SEPS would not be eliminated; only SAR-SEPs would be eliminated.

On April 25, 1996, a group of 22 Republican and Democratic senators issued their proposal to balance the federal budget over seven years. In general, their plan would not include as many tax cuts as the Republican proposal. But there would be IRA changes, many of which have already been proposed by the leaders of the Democrats and Republicans. The adjusted gross income limits would be expanded. There would be penalty-free withdrawals for first time home buyers, catastrophic medical expenses, higher education costs and extended unemployment. The back-ended IRA would be authorized. There would be a $250 per child tax credit (rather than the $500 as proposed by Republicans) for all children under age 17. This credit would be increased to $500 if the additional $250 was contributed to an IRA.

On May 16, 1996, a bipartisan group in the House of Representatives announced their support of legislation which would expand IRAs. The reason is that expanded IRAs would help improve the national savings rate and also be one component in resolving people's concern about the source of their retirement income. This group issued the results of a survey. One of the findings of this survey was that 64 percent of the adults sampled said they would increase their personal savings if the IRA rules were expanded.

In summary, many politicians seem convinced that expanding IRAs would be a good change. There is even some talk that there might be a tax bill passed prior to the November elections. Again, time will tell. PD

Tax Extensions — Effect on SEPs, QPs and IRAs

Tax Extensions — They work for SEPS, profit sharing and money purchase plans. They don't work for IRAs.

Any business (including a one-person business) which has an extension with respect to its 1995 tax return may still make a carryback contribution for tax year 1995 to either a SEP or a profit sharing or a money purchase plan.

In the case of a profit sharing and a money purchase plan, the plan must have been in existence by the last day of the tax year (normally December 31) to be eligible to receive a carryback contribution for the prior tax year.

In the case of a SEP, the business may still establish the plan and fund it if it has a valid extension.

The contribution deadline for tax year 1995 for IRAs is April 15,1996. This deadline is not extended even if the taxpayer has received an extension on filing his or her tax return. PD

Also in this issue –

Rollovers to IRAs From Section 403(b) Annuities

A "Be Careful" Situation

The Pension Digest has not contained many articles on section 403(b) annuities. The reason is that most banks, savings and loans and credit unions are not able to service such plans because of legal restrictions on how tax-sheltered annuity money must be invested.

The term, "tax sheltered annuity (TSA)" is used to describe a special type of retirement program which gets tax-deferred treatment. By law, a TSA requires funds to be invested in annuity contracts issued by an insurance company, in custodial accounts holding mutual fund shares, or in certain retirement income accounts as designed for a church. The law does not provide for investing in time deposits, savings accounts, individual stocks, bonds, etc. The only way this law will be changed is to seek a law change making deposit vehicles and individual stocks and bonds permissible investments for TSAs.

Conceptually, a TSA is most similar to a 401(k) plan. An employee of an employer who sponsors a TSA plan may electively defer a portion of his or her salary. This amount is contributed to an annuity/account and the individual thereby lowers his or her current taxable income and does not pay taxes on the earnings of the investments until distribution occurs. Special rules apply to a 403(b)/TSA plan. A TSA is not a qualified plan.

Only two types of employers are authorized by the law to sponsor a section 403(b) plan—public schools and certain tax-exempt organizations. Generally, a tax-exempt organization qualifies if it is tax exempt because it is organized and operated exclusively for religious, charitable, scientific, public safety testing, literary or educational purposes. It also includes a tax-exempt organization that is organized and operated exclusively to encourage national or international amateur sports competition or for the prevention of cruelty to children or animals.

Purpose of Article

The purpose of this article is to discuss rollovers from a TSA/403(b) to an IRA and to emphasize that an IRA custodian/trustee still should be obtaining a signed rollover certification form from a person making a rollover or direct rollover from a TSA/403(b) annuity/account to an IRA.

The law permits such rollovers if certain rules are met. Participants in 403(b) plans, and employers who sponsor such plans, may be unaware of some rules. Oftentimes an employer or an employee may sometimes choose to ignore such rules or to plead ignorance of such rules. As an IRA custodian you will wish to be aware of these rules and establish the necessary policies and procedures to limit your possible problems.

Internal Revenue Code section 403(b)(8) sets forth the rules regarding what distribution from a section 403(b) annuity qualifies to be rolled over (i.e. not presently included in gross income). That is, Code section 403(b)(8) sets forth the rollover rules and not the direct rollover rules.

Code section 403(b)(10) requires section 403(b) annuities/accounts to contain a provision allowing a 403(b) participant to elect to have a direct rollover rather than having an actual distribution.

The rules to roll over an actual distribution are:

1. The amount paid to the employee/recipient must qualify as an eligible rollover distribution within the meaning of Code section 402(c)(4). In general, any distribution qualifies as an eligible rollover distribution as long as it is not a required minimum distribution or one which is part of a series of payments over a period of 10 years or more.

2. The recipient must redeposit or transfer such distribution or any portion of such distribution into an IRA or another section 403(b) annuity/account.

3. If the recipient has received property other than cash, then he or she must transfer the property which was distributed.

4. Rules similar to the rules found in Code section 402(c)(2) through (7) shall apply. The maximum amount which may be rolled over is the taxable amount. The rollover must be completed within 60 days. The special rules which apply to the sale of distributed property as set forth in (6) will apply as do the rules for frozen deposits as set forth in (7).

The rules discussed so far do not seem to cause any administrative problems for an IRA custodian/trustee. There is, however, a rule found in Code section 403(b)(11) which does cause some special administrative problems. Code section 403(b) (11) is set forth below:

"(11) Requirement That Distributions Not Begin Before Age 59 1/2, Separation From Service, Death or Disability. ." — This subsection shall not apply to any annuity contract unless under such contract distributions attributable to contributions made pursuant to a salary reduction agreement (within the meaning of section 402(g)(3)(C) may be paid only:

(A) when the employee attains age 59 1/2, separates from service, dies, or becomes disabled (within the meaning of section 72(m)(7); or

(B) in the case of hardship.

Such contract may not provide for the distribution of any income attributable to such contributions in the case of hardship.

Code section 403(b)(11) was added by The Tax Reform Act of 1986. A definition game is played. An annuity does not qualify as a section 403(b) annuity/account if there is a distribution for a reason other than being 59 1/2, death, disability or separation from service. In plain English, this means that a school teacher or a hospital employee who is not 59 1/2 and who has not separated from service may not roll over his or her TSA into an IRA, but see the exception or clarification discussed below. If such a distribution would occur, such a distribution would not be from a section 403(b) annuity and thus would not qualify to be rolled over into an IRA. Any purported rollover would most likely be an excess IRA contribution to the extent it exceeded the standard $2,000 contribution limit.

In a special letter ruling dated May 19, 1995, the IRS furnished the following explanation and clarification as to the effect of Code section 403(b)(11). The IRS construes section 403(b)(11) as applying only to years beginning after December 31, 1988, and only with respect to distributions attributable to assets accumulated on or after January 1, 1989. That is, assets held as of December 31, 1988, are not governed by the new rule. These pre-1989 amounts are eligible to be rolled over or directly rolled even if the school teacher or hospital employee has not separated from service as long the distribution qualifies as an eligible rollover distribution.

It is still important that an IRA custodian/trustee obtain a signed rollover certification form from a person wishing to roll over funds from a 403(b) annuity to an IRA.

Second Reason to Use a Rollover Certification Form

Within the last 24 months, the IRS has come to the conclusion that many 403(b) plans have not been complying with the rules. The IRS has come to this conclusion after conducting numerous audits. The IRS has developed a VCR (Voluntary Compliance Resolution) program. This

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IRAs and Disability — A Recent Tax Court Case

A question which arises quite frequently for an IRA administrator is whether or not an IRA accountholder is disabled for IRA purposes and how the IRA custodian/trustee should handle an accountholder's inquiry or statement that he or she is disabled. A distribution to an IRA accountholder who is younger than 59 1/2 will not be subject to the 10% excise tax of Code section 72(t) if he or she is disabled within the meaning of Code section 72(m)(7).

"... an individual shall be considered to be disabled if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration. An individual shall not be considered to be disabled unless he furnishes proof of the existence thereof in such form and manner as the Secretary may require."

The Secretary has created a form for this purpose. It is the Schedule R form. The pertinent portions of this form are set forth below, and as you will observe, it essentially repeats the statutory language. If an IRA accountholder brings the IRA custodian/trustee a signed Schedule R form, then the IRA custodian/trustee should prepare the Form 1099-R with a reason code 3 in box 7 unless there was some reason to indicate to the IRA custodian that the Schedule R form was not valid. For example, the person who signed the form was not a doctor, or the purported doctor's signature was a forgery and for some reason the personnel of the IRA custodian knew this.

The important point is this - a person may be considered disabled for other purposes such as social security or a specific job, but not be considered disabled for IRA purposes. An IRA custodian must always ask to be furnished a signed Schedule R form. Once this is done, the IRA custodian has done its job and the IRS will look to the individual and the doctor to determine if the individual was actually disabled for IRA purposes.

Recent Tax Court Case—Taxpayer was not Disabled for IRA Purposes

In Dwyer v. Commissioner of Revenue, USTC, No. 2626-95, 5/15/96, the court held that the taxpayer, Mr. Dwyer, was not disabled within the IRA meaning since he was not prevented from engaging in substantial gainful activity. Therefore, he owed the 10% excise tax as he had received a distribution before age 59 1/2.

Mr. Dwyer was a stock trader. In 1989 he was diagnosed as having a biochemical depression and was treated with anti-depressant medications. It was argued that his depression was related to some very large trading losses, and possibly related to involvement in a stressful lawsuit with his partners. He had withdrawn $208,802 from his IRA for himself. He had continued to be a trader although he continued to experience losses and he needed medical supervision.

The court found that he still was engaged in a substantial gainful activity. The fact that he had lost money was not the test. He had attempted to make a profit. The court did not accept Mr. Dwyer's argument that since he had lost money, he was not and could not be engaged in any substantial gainful activity. Since he was involved in an attempt to make a profit, he was engaged in a substantial gainful activity and thus was not disabled for IRA purposes. He owed an excise tax of $20,880 on the pre-59 1/2 distribution of $208,802.

An IRA custodian as a reporting entity does not determine if a person is disabled for IRA purposes. A doctor must determine that result. Therefore, the IRA custodian must ask to be furnished a signed Schedule R form. PD

Schedule R
(Form 1040)
Department of the Treasury
Internal Revenue Service (99)

Credit for the Elderly or the Disabled

▶ Attach to Form 1040. ▶ See separate instructions for Schedule R.

OMB No. 1545-0074
1995
Attachment Sequence No. **16**

Name(s) shown on Form 1040 | Your social security number

Part II **Statement of Permanent and Total Disability** (Complete **only** if you checked box 2, 4, 5, 6, or 9 above.)

IF: 1 You filed a physician's statement for this disability for 1983 or an earlier year, or you filed a statement for tax years after 1983 and your physician signed line B on the statement, **AND**

2 Due to your continued disabled condition, you were unable to engage in any substantial gainful activity in 1995, check this box . . . . ▶ ☐

- If you checked this box, you do not have to file another statement for 1995.
- If you **did not** check this box, have your physician complete the statement below.

Physician's Statement (See instructions at bottom of page 2.)

I certify that ______________________
Name of disabled person

was permanently and totally disabled on January 1, 1976, or January 1, 1977, **OR** was permanently and totally disabled on the date he or she retired. If retired after 1976, enter the date retired. ▶ ______

Physician: Sign your name on **either** line A or B below.

A The disability has lasted or can be expected to last continuously for at least a year . . . . ______ Physician's signature ______ Date

B There is no reasonable probability that the disabled condition will ever improve . . . . ______ Physician's signature ______ Date

Physician's name | Physician's address

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11359K **Schedule R (Form 1040) 1995**

Instructions for Physician's Statement

Taxpayer
If you retired after 1976, enter the date you retired in the space provided in Part II.

Physician
A person is permanently and totally disabled if **both** of the following apply:

1. He or she cannot engage in any substantial gainful activity because of a physical or mental condition, and

2. A physician determines that the disability has lasted or can be expected to last continuously for at least a year or can lead to death.

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403(b) Annuity—*Continued from page 2*

program requires the sponsoring employer to make a cash payment to resolve the past deficiencies and then make whatever changes are necessary to start doing things correctly. Rather than coming up with any money, some employers have simply chosen to terminate their "old" 403(b) plans and start a new complying 403(b) plan. A major question exists as to whether or not a participant in a non-qualifying 403(b) plan who receives a distribution is eligible to roll over such funds to an IRA. The IRS most likely would win its argument that such distributions are not eligible to be rolled over and they would constitute excess IRA contributions if a rollover were attempted. In some situations, you as an IRA custodian/trustee, may wish to refuse such rollover deposits if you have good reason to doubt whether the distributing 403(b) plan was "good." If you do accept a rollover, then in all situations you will want to use an IRA rollover certification form. PD

4 Federal Preemption/Beneficiary Waiver Cases

This article summarizes three cases from different United States Courts of Appeals and one case from a state court. These cases certainly have meaning for administering qualified plans and may also have some meaning for administering IRAs. These cases clearly demonstrate that the Circuit Courts are not reaching the same conclusions.

The first case comes from the Fourth Circuit. The case is, Estate of Thomas Angello Altobelli v. International Business Machines Corporation, et al, U.S. Court of Appeals, 4th Circuit, No. 94-1592, February 28, 1996. Mr. Altobelli died four years after being divorced. Mr. Altobelli was a participant of a qualified plan. A life insurance policy had been purchased under the plan for the benefit of Mr. Altobelli. He had named his ex-wife as his beneficiary of this policy, and he did not change this designation after the divorce. He had not designated a beneficiary under the plan. However, the plan contained a provision that stated in this situation that the beneficiary of the plan would be the same as that designated under the policy. At the time of the divorce, the ex-wife signed a divorce decree wherein she surrendered any rights she had under the pension plans.

Mr. Altobelli's estate sued the plan. The plan argued that the ex-wife was entitled to the plan proceeds because ERISA requires a plan administrator to follow the terms of the plan and that to not follow the plan to the letter would violate ERISA's anti-alienation provisions. The court, however, ruled for the estate. The divorce decree indicated the intent of Mr. Altobelli and his ex-wife was to relinquish her rights.The ex-wife had effectively waived her benefits via the divorce decree. The court did not see the fact that the plan administrator had to deal with a court order other than a QDRO (qualified domestic relations order) as such a hardship that the plan administrator should be able to disregard it.

The second case comes from the Sixth circuit. The case is, Metropolitan Life Insurance Company v. Mary M. Pressley, et al, U.S. Court of Appeals, No. 94-2093, April 18, 1996. A participant designated his spouse as a beneficiary of a life insurance policy under a plan subject to ERISA. Five years later the participant was divorced from Mary M. Pressley. Under Michigan law, Mary Pressley was required within the divorce decree to waive any claims to a spouse's benefits under a life insurance policy. The participant died nine years later and the participant had never changed the insurance beneficiary designation. Both Mary Pressley and the participant's estate filed claims for the policy proceeds. The representative of the estate argued she had waived any interest. Mary Pressley argued that the Michigan law was preempted by ERISA and that she was entitled to the funds because she was still the named beneficiary. The district court ruled for Mary Pressley as did this appellate court. The court noted that the ERISA preemption provision is broad and that any law which relates to a plan is preempted. The Michigan law clearly required the plan administrator to look to the divorce decree to determine the proper beneficiary. This was interference with an ERISA plan and is not permitted by the ERISA preemption provision.

The third case comes from the Fifth circuit. The case is, Sandra Jean Dale Boggs v. Thomas F. Boggs, U.S. Court of Appeals, Fifth Circuit, No. 94-30178, April 17, 1996. Thomas Boggs was a participant in a qualified plan. His first wife predeceased him in 1979. Sandra Jean was his second wife. The first wife had given, via her will, her one-half interest in all vested pension benefits acquired during the marriage to her children. Under Louisiana community property law, each spouse owns an undivided one-half interest in all vested pension benefits acquired during a marriage. The children were to receive their share after Mr. Boggs died. Mr. Boggs remarried. He later retired. He received some of his benefit in a lump-sum distribution, and he was also paid a monthly annuity. Mr. Boggs died in 1989. The children of Mr. Boggs filed an action in state court to receive their share. The second wife (Sandra Jean) then exercised her right under federal law to move the case to federal district court. She argued that Louisiana community property law was preempted by ERISA. The district court ruled against the second wife and so did the Fifth circuit. Although the ERISA preemption provision is very broad, the Court ruled that it does have limits and applies only to laws that relate to benefit plans. The court concluded that the Louisiana community property law did not relate to the plan since the concept was that the plan would pay the second spouse who must then turn the children's share over to them. That is, the court did not rule that the plan must pay the children their share.

The fourth case comes from the Commonwealth of Massachusetts. The case is, Wennett V Capone, Mass SuperCt Middlesex, No. 9206560-A, March 7, 1996. This case also dealt with the situation where there was divorce, a waiver under a divorce decree and a failure by the participant spouse to affirmatively change his beneficiary designation. This court acknowledged that the spouse's waiver was not technically a qualified domestic relations order. In general, ERISA mandates that no one (and especially a state court) has the authority to alienate a participant's plan benefit unless the court order is a qualified domestic relations order. A waiver in a divorce decree is not a QDRO. This court noted that the First Circuit had not not yet ruled on this issue. This court decided to follow the Seventh Circuit. The court then concluded that Congress did not intend to limit the ability of plan beneficiaries to waive their rights. A waiver is different from an alienation.

These four cases demonstrate how various courts have ruled when presented with the situation where a participant has obtained a waiver from his or her ex-spouse under a divorce decree, but then has (intentionally or because of laziness) not changed his or her beneficiary designation, and then dies. Although the ex-spouse has signed a waiver, ERISA contains rules which expressly prevent a plan participant or beneficiary from alienating his or her benefits. ERISA also contains rules to protect plan administrators. The concept is, a plan administrator shouldn't have to be concerned about other laws as long as they follow the rules and procedures set forth in the plan document. The participant spouse could have changed his or her beneficiary designation. Three of these cases were decided against the ex-spouse. One case ruled for the ex-spouse. It appears that The United States Supreme Court will need to settle the split between the circuits. This author will guess that the United States Supreme Court will rule that the plan administrator should be able to rely on the last beneficiary designation as provided by the plan participant, and therefore the ex-spouse will win.

If these courts have been willing to rule that a divorce decree overrides a specific beneficiary designation form for qualified plan participants, it is very likely that courts will be willing to override IRA beneficiary designations if there was a prior waiver under a divorce decree. As an IRA custodian, you will wish to consult with your attorney if one of your IRA accountholders dies and he or she has designated an ex-spouse as the beneficiary. Your attorney can then determine if a court case should be commenced so that a court can determine who the proper beneficiary is. Some states (MI or LA) do have laws clearly stating that the designated beneficiary of the IRA is entitled to the IRA funds regardless of other conflicting legal documents, such as divorce decrees or wills. PD