THE Pension Digest

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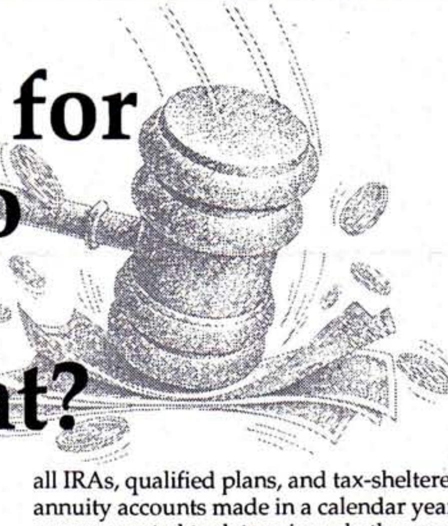
A Penalty for Saving too Much for Retirement?



Many people are unaware that there is a 15% excise tax imposed on retirement plan distributions that exceed a certain amount. This excise tax can also apply at the time of a person's death if the balances in their retirement plan exceed a specified dollar limit. This article will discuss when this excise tax will apply and how it works.

Excess Distributions

The Tax Reform Act of 1986 contains provisions that require retirement plan distributions, that exceed certain amounts in a calendar year, become subject to a 15% excise tax. The amount to which this tax will apply depends on whether or not the distribution is a lump-sum distribution. It also depends on whether or not the individual in question elected a special "Grandfather Method" for calculating this tax. Certain individuals were allowed to make an election on their 1988 tax return that would exclude a certain portion of the dollars held in their retirement plans from this excise tax. Individuals who had balances in their retirement plans that exceeded $562,500 on August 1, 1986, were permitted to make a special election. This election exempts some of the retirement plan assets from this excise tax. Basically the concept is that a portion of the retirement plan distribution will not be subject to this tax, but some portion may be.

1. Non-Lump-Sum Distributions

If the distribution is not a lump-sum distribution, the 15% excise tax applies to the amount of the distribution, made in a calendar year which exceeds the greater of $150,000, or $112,500* as indexed for inflation if the special grandfather election was made. All non-lump-sum distributions from all IRAs, qualified plans, and tax-sheltered annuity accounts made in a calendar year are aggregated to determine whether or not this tax applies. Any person who made the special "Grandfather Election" explained above must use the smaller indexed figure when calculating the excise tax.

If the grandfather election was made, there are two formulas that are used to determine what portion of a distribution falls under the exemption and what portion may be subject to the tax. They are called the Discretionary Method and the Attained Age Method. The calculation performed under these formulas should be done by the individual's tax advisor and not the IRA or retirement plan custodian/trustee.

Example - John made the grandfather election in 1988. In 1995, he takes a distribution of $142,000 from his IRA. The formula he is using indicates that $80,000 falls under the grandfather exemption. This means that $62,000 is not covered by the exemption. However, since this amount is less than the $150,000 indexed amount in 1995, none of the distribution would be subject to the excise tax.

As each distribution is made, a portion of the grandfather amount is used. When the entire grandfather amount is exhausted, all future distributions may be subject to the excise tax.

2. Lump-Sum Distributions

If the distribution was a lump-sum distribution, where the recipient elected to use income averaging and/or capital gains treatment, the excise tax is imposed on the amount of the lump sum that exceeds the

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Status of IRA and Pension Legislation

On May 22, The House of Representatives in a 414-10 vote, passed the Small Business Jobs Protection Act. On June 12 the Senate Finance Committee added four pension provisions. The full Senate will be voting on this bill, as revised, in early July.

First, the spousal IRA limits would be increased from $2,250 to $4,000 effective as of January 1, 1997.

Second, the IRS would be required to develop model Qualified Domestic Relation Order forms.

Third, the IRS would be required to develop model Qualified Plan Survivor Annuity and Qualifed Joint Survivor Annuity forms.

Fourth, there would a number of changes to the rules governing Employee Stock Ownership Plans (ESOP). Many of the changes are considered to be pro-ESOP, but such description cannot be given to the one proposal to repeal the present rule which provides for a financial institution which makes an ESOP loan to exclude from its income 50% of the interest income. It appears that the Democrats and Republicans may reach a compromise on minimum wage legislation and health insurance/MSA changes so that some new laws affecting IRAs and pension plans may be enacted. PD

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greater of $750,000, or $562,500* (or five times the annual indexed amount) as indexed if the grandfather election was made. As with non-lump-sum distributions, any person who used the grandfather election must use the indexed amount to calculate the penalty.

a. Lump-Sum Distribution - In order to be a lump-sum distribution, the distribution must be from an employer-sponsored qualified retirement plan, and the distribution must be 100% of the individual's account balance in that plan. It must be distributed in one calendar year, due to the attainment of age 59 1/2, death of the individual, disability, or separation from service. Additionally, in order to qualify as a lump sum, the distributions must consist of 100% of the balance of all like plans maintained by the employer. This means, for example, that if an employer had a profit sharing plan and a 401(k) plan, 100% of the account value in both would need to be distributed to an individual to qualify as a lump-sum distribution. On the other hand, if the employer had a profit sharing plan and a pension plan, a lump-sum distribution could be made from either one of the two plans independently, as these are not considered "like" plans. It is important to notice that the rules under the lump-sum distribution portion of the law do NOT apply to IRA distributions. All IRA distributions are classified as non-lump-sum distributions for purposes of this excise tax.

*NOTE: The indexed amounts under the grandfather election for 1995 were $150,000 and $750,000 respectively. For 1996 the indexed amounts are $155,000 and $775,000. As the indexed amount now exceeds the base amount specified in these rules, all individuals now use the indexed amount to determine the penalty tax.

3. Distributions Not Subject to the Excise Tax

a. Distributions to a beneficiary upon the participant's death will not be subject to this tax. Such distributions may, however, be subject to the estate tax of 15% on excess retirement accumulations.

b. Distributions to a former spouse under a Qualified Domestic Relations Order (QDRO), when included in the income of the recipient, will not be subject to the tax as per the accountholder but they will be subject to the excise tax as to the recipient.

c. Distributions attributable to the individual's after-tax contributions.

d. Distributions that are rolled over will not be subject to the tax at that time but will be upon later distributions.

e. Distributions of an annuity contract where the value of the contract is not included in income at the time of the distribution.

f. Distributions of excess deferrals or contributions are not subject to the tax.

4. Other General Considerations

a. The 15% tax is reduced by the amount of any 10% premature distribution tax that is imposed.

b. Required minimum distributions are included in computing the amounts subject to this tax.

c. All retirement plan distributions in a calendar year from qualified plans, IRAs, and tax-sheltered annuity plans are aggregated to determine the amount subject to this tax.

d. If a person receives a lump-sum distribution from a qualified plan, and non-lump-sum distributions from other retirement plans in the same year, the penalty tax is applied separately to each type of distribution. The lump-sum portion is subject to those rules, and the non-lump-sum portion to the rules governing that type of distribution. For example, if in the same year a person were to receive a $325,000 lump-sum distribution from his employer's 401(k) plan and $125,000 distribution from his IRA, none of the money would be subject to the penalty taxes as each amount is under the threshold for that type of distribution.

Excess Retirement Accumulations and Estate Tax

A 15% excise tax for excess retirement accumulations may be imposed on an individual's estate when the individual dies. The tax is owed when the combined interest of the individual's qualified plans, tax sheltered annuity plans, and IRAs exceed an amount equal to the present value of a hypothetical life annuity paying $150,000 a year. The tables used to make this valuation are found in IRS Announcement 89-60.

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IRS Issues Final Regulations on TINs

Within the last 30 days, the IRS has issued final regulations relating to requirements for furnishing a taxpayer identifying number on returns, statements or other documents. The final regulations contain two principal changes to the proposed regulations which were issued on September 27, 1990. These final regulations are generally effective as of May 29, 1996. However, the requirement that certain foreign persons must have a taxpayer identification number in order to file a tax return is effective for tax returns filed after December 31, 1996.

These regulations certainly apply to IRAs, SEPs and qualified plans, but these rules will also impact other areas of your financial institution. Every IRA accountholder must furnish a social security number when he or she establishes an IRA.

All beneficiaries (including estates) who have inherited an IRA must furnish a social security number, a nine-digit (xxxxxxxxx) employer identification number, or "Individual Taxpayer Identification Number" (ITIN) unless they are a nonresident alien.

Section 6109 of the Internal Revenue Code requires most every person or legal entity to furnish his or her taxpayer identification number when he or she files a tax return or when he or she deals with a third party who is required to prepare a reporting form. There are monetary penalties for not having or providing such a TIN.

The first principal change of the final regulations is that the IRS has created a new IRS-issued TIN called an IRS individual taxpayer identification number (ITIN). It is to be used by alien individuals, whether resident or nonresident, who currently do not have, and are not eligible to obtain social security numbers. Certain aliens are not eligible to be given a social security number, but these people must still comply with the IRS rules requiring them to have a TIN. The Social Security Administration will normally issue a social security number only to individuals who are U.S. citizens, or alien individuals who are legally admitted to the U.S. for permanent residence or under other immigration categories which authorize U.S. employment.

Any individual who is not eligible to obtain a social security number and is required to furnish a TIN must apply for an IRS individual taxpayer identification number on Form W-7, "Application for IRS Individual Taxpayer Identification Number." The IRS will begin accepting applications for TINS on the Form W-7 on or after July 1, 1996.

A foreign person must request and submit the Form W-7 sufficiently in advance of the first required use of the ITIN to permit issuance in time to have the number as required. The individual will need to furnish the information requested by Form W-7 — name, address, foreign tax identification number and the specific reason he or she needs to be assigned an ITIN. The IRS will also request to be furnished documentary evidence proving the person's alien status, e.g. passport, driver's license, birth certificate, identity card, or immigration document.

The second principal change is to change the rule so that an alien may only file a U.S. tax return if he or she has

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1. Amounts not Subject to this Tax

a. Any amounts payable to an alternate payee under a QDRO.

b. Any interest attributable to the individual's own after-tax contributions.

c. Any part of the interest that is purely death benefit (i.e. the difference between the account value immediately prior to and following the death).

2. Spouse Beneficiary

There is a spousal election available to the spouse of a participant whose estate may be subject to this tax. The spouse can elect not to have the estate tax apply. The distributions from the decedent's plans are then aggregated with the surviving spouse's own retirement plan distributions and may be subject to the 15% excess distribution tax discussed earlier. At the time of the spouse's death, the spouse's estate could be liable for the estate tax. This election can only be used if the spouse is the beneficiary of all the interests subject to the estate tax.

If the spouse does not make this election, and receives distributions from the plans on which the tax is paid, the spouse can still roll over the funds into an IRA. They must be kept in an IRA which is separate from any other IRA the spouse may have, as these funds will never again be subject to either the excess distribution or excess accumulation tax, as long as they are kept in an IRA that contains no funds other than this rollover. PD

IRS to Meet on Proposed Regulations for Withholding for Nonresident Aliens

A companion article in this newsletter discusses final regulations which the IRS has recently issued with respect to taxpayer identification numbers (TIN). One of the primary reasons for the new regulations was the administrative problems associated with nonresident aliens not having a tax identification number (normally a social security number). The IRS certainly gave the issuance of these regulations a fast track treatment.

In May of 1996, the IRS issued proposed regulations covering the withholding rules for foreign persons. These proposed rules are very comprehensive and will be important for many reasons in addition to IRA/pension reasons. The IRS is holding a meeting on July 24, 1996, to discuss the new proposed regulations. As with the TIN regulation, it appears the IRS is giving super-fast track treatment to these regulations .

The August 1995 issue of this newsletter covered the withholding of tax on IRA and pension distributions to nonresident aliens. In general, because IRAs and pensions have been considered to be related to a U.S. business, Code section 3405 (the general withholding rules) have been considered to govern withholding even for nonresident aliens rather than Code section 1441 which specifically applies to nonresident aliens.

The new proposed regulations would change the IRS' approach for distributions from a qualified plan (section 401 (a)), a section 403(a) annuity or a section 403(b) annuity or account. The regulation does not expressly mention IRAs, so it is unclear whether and how IRAs would be covered by the new rules. Under the new proposed rules, payers of distributions to nonresident aliens would be required to withhold from the distributions in accordance with the section 1441 rules rather than the Code section 3405 rules. The proposed regulations would be effective for payments made beginning in 1998.

The new proposed rules would allow the payer to presume that a payment is being made to a U.S. person if the payer has both a social security number and a mailing address in the U.S., or in certain foreign countries with which the U.S. has an income tax treaty. Otherwise the payer may presume the person is a nonresident alien. For this purpose, an income tax treaty must provide that the payee, if an individual resident in that country, would be entitled to an exemption from U.S. tax on these payments. We will be writing the IRS to ask that they expressly state whether or not, and how, IRAs are covered under the new rules. PD

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obtained an ITIN. In the past this was required only if the foreign person had income effectively connected to a U.S. trade or business, had a U.S. office or place of business, or a had U.S. fiscal or paying agent at any time during the tax year,

Set forth below is a summary of the final regulation's rules.

Types of Taxpayer Identification Numbers

There are now three types: social security numbers (xxx-xx-xxxx), employer identification numbers (xx-xxxxxxx) and IRS-issued individual taxpayer identification numbers (xxx-xx-xxxx).

A citizen of the U.S. is required to use his or her social security number. However, those individuals who do business as a sole proprietor must use an EIN when required by the IRS to do so.

A foreign person is required to use his or her social security number if he or she has been assigned one or is eligible to be assigned one. However, those foreign person who are sole proprietors with U.S. connections must use an EIN when required by the IRS to do so.

A foreign person who is not eligible to be assigned a social security number must obtain an ITIN from the IRS. However, those foreign persons who are sole proprietors with U.S. connections must use an EIN when required by the IRS to do so.

Any person other than an individual (such as corporations, partnerships, nonprofit associations, trusts, estates, etc.) must obtain and use an employer identification number. The Form SS-4 is filed with the IRS to obtain an EIN.

Requirement to Furnish One's Own Taxpayer Identification Number

If one is required to file a tax return, statement or other tax document, then that person must furnish its own taxpayer identifying number.

A person whose taxpayer identifying number must be included on a document filed by a third party must give his, her or its taxpayer identifying number to the third party on request. Failure to do so will mean the IRS can impose a $50 penalty.

Requirement to Furnish Another's Taxpayer Identification Number

Your financial institution must prepare numerous reporting forms for the IRS. Examples are: Form 1099-INT, Form 1099-R and Form 5498. You are required to include your customer's TIN on these forms and statements. If for some reason you do not know the TIN of a specific customer, you must request that the person furnish it to you. Your request must state that the law requires him or her to furnish this identifying number.

If your financial institution has requested the number and it still is not furnished to you, then when your institution's transmittals are sent to the IRS, there should be an affidavit submitted with the transmittals and returns demonstrating that you did comply with the request requirement, but the number(s) still was not furnished.

Summary

The IRS has issued final regulations with respect to TINs. The IRS concluded that it needed to be able to issue a separate tax identifying number to certain foreign persons who did not qualify to be issued a social security number.

Thus, the IRS has created a Form W-7 to be used by a foreign person to request a special IRS taxpayer identifying number. A foreign person who files a tax return with the United States must have a TIN or an ITIN for all returns filed on or after December 31, 1996. PD

IRS Asks for Comments on Form 1099-R and Form W-4P

The IRS has asked for comments from the public regarding two forms — Form W-4P, Withholding Certificate for Pension or Annuity Payments; and Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.

A person may submit comments on the following subjects: whether or not the forms seek needed information, ways to improve the forms, the accuracy of the department's estimate of the paperwork burden on the taxpayers, and ways to lessen the paperwork burden.

If you wish to send your comments, you should send them to Garrick R. Shear, Internal Revenue Service, Room 5571, 1111 Constitution Avenue NW, Washington, DC, 20224. He should receive them on or before August 23, 1996. PD

IRS Issues Final Regulations With Respect to Form 945

A financial institution must annually file Form 945 (Annual Return of Withheld Federal Income Tax) to report the amounts it withheld with respect to nonpayroll items.

The IRS had issued a temporary regulation on October 16, 1995, and then, after only minor changes, adopted it as a final regulation on May 30, 1996. The final regulations provide that a financial institution or any other person is required to file the Form 945 only for a calendar year in which it is required to withhold federal income tax from a nonpayroll payment. Prior to the issuance of the temporary/final regulation, the rule was that once an institution was required to file a Form 945, it then must file the form for all subsequent years. For example, an IRA custodian who was required to withhold federal income tax in 1995 and 1998 but not in 1996 or 1997 (because all payees instructed the IRA custodian to not withhold) would not be required to file the 1996 or 1997 Form 945, but would be required to file the 1995 and 1998 Form 945. This example assumes that the financial institution also was not required to withhold for 1996 and 1997 with respect to any of the other types of nonpayroll payments subject to withholding.

Withholding with respect to the following types of nonpayroll payments must be reported on Form 945:

1. Pensions, annuities, IRAs and certain other deferred income subject to withholding under section 3405;

2. Reportable payments subject to backup withholding;

3. Certain gambling winnings;

4. Certain retirement pay for services in the Armed Forces of the United States; and

5. Certain annuities described in section 3402(o)(1)(B). PD

✓✓✓ Check It Out ✓✓✓

Question: Does the alternative certification method apply to inherited IRAs as well as to regular IRAs?

✓ Answer. Yes. The IRS created the alternative certification method in 1988 when it issued Notice 88-38. A person who is required to take a required minimum distribution, and who has more than one IRA, must calculate the required minimum distribution for each separate IRA, but he or she is allowed to aggregate the various required minimum distribution amounts, and then take a distribution equaling the aggregated total from just one IRA. This special rule applies to inherited IRAs as well as regular IRAs.

The following situation is presented to illustrate one situation when the alternative method can be put to good use. This illustration does not include an inherited IRA because the surviving spouse, in this example, elects to treat his deceased spouse's IRA as his own.

Tom and Karen Fernandez are both age 76 in 1995, and both have IRAs. Each had named the other as his or her sole beneficiary. Their respective RMD calculation both used a joint life-expectancy and the recalculation method. The balance in Karen's IRA as of December 31, 1994, was $60,000. The balance in Tom's IRA was $40,000. The factor from the joint life expectancy table is 15.7. Thus, the 1995 required minimum distribution for Karen was $3,821.66 and $2,547.77 for Tom. They took these distributions in May of 1995. Karen died on June 15, 1995. Tom elected to treat her IRA as his own on November 10, 1995. He named his daughter Sabina as the sole beneficiary of this new IRA and also his "original" IRA.

The balance in his "original" IRA as of December 31, 1995 was $39,500. He is age 77 in 1996, so the factor is 11.2. He must now use a single life-expectancy factor because he had elected to use the recalculation method, and a zero must now be used for Karen since she has died. His required minimum distribution with respect to this IRA for 1996 is $3,616.07.

The balance in his "new" IRA as of December 31, 1995, is $59,500. Since his daughter is more than 10 years younger, the MDIB table applies and the divisor will be 20.1. His required minimum distribution for 1996 with respect to this IRA is $2,960.20.

Thus, his total required minimum distribution for 1996 is $6,576.27.

The planning issue is — from which IRA or IRAs does he wish to withdraw the $6,576.27. A good argument can be made that the entire $6,676.27 should be withdrawn from his "original" IRA. The reason is that he elected to use the recalculation method with respect to this IRA. Consequently, after his death, Sabina would be required to withdraw the entire remaining balance on or before December 31 of the year following the year of his death. The current balance is $39,500. From a tax planning standpoint, it is desirable to reduce this balance as much as possible relative to the balance in his new IRA. Therefore, as long as the alternative method exists, Tom should take his withdrawals from the "original" IRA so that he can deplete its balance as rapidly as possible. In a certain sense, the alternative method gives him the opportunity to undo his election of the recalculation method which he made with respect to his "original" IRA. PD

The Pension Digest invites your questions and comments. Please address to "Check It Out," Collin W. Fritz and Associates, Ltd., P.O. Box 426, Brainerd, MN 56401.