THE Pension Digest

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2 Court Cases Expand Deadline for Correcting a Current-Year Excess Contribution

Internal Revenue Code section 408(d)(4) indicates that a current year/excess contribution can be "corrected" if three requirements are met.

First, the income which relates to the excess contribution must be withdrawn.

Second, the IRA contributor/taxpayer must not have claimed a deduction with respect to the contribution.

Third, the IRA contributor must withdraw the excess contribution on or before his or her deadline (including extensions) for filing that year's tax return. If the excess contribution is corrected in a timely fashion, then the special 6% excise tax for having made an excess contribution will not be owing nor will the distribution of the contribution amount be included in income for taxation purposes.

The statutory language seems quite clear with respect to the third requirement. The withdrawal must take place on or before the tax filing deadline. Normally this deadline is April 15.

Two recent court cases have considered the situation where the IRA accountholder gave notice to the IRA custodian prior to the filing deadline that he or she wanted to withdraw the contribution previously made; but for some reason, the IRA custodian did not accomplish the task until after the filing deadline. The two court cases have adopted a position favorable to the IRA accountholder. They ruled that even though the taxpayer actually received the withdrawal of the contribution after the person's due date, they were still entitled to the favorable tax treatment bestowed by Code section 408(d)(4).

The United States Tax Court, in the case of James G. and Shirley L. Thompson v. Commissioner of Internal Revenue (6-11-96) considered the following situation. Mr. Thompson was a participant in a defined benefit plan. He received a lump-sum distribution of $163,474.26 of which $136,877.04 was taxable. He elected to roll over the amount of $136,877.04. The original tax return for 1989 was filed in February of 1990, and reflected the non-taxable rollover. The taxpayers changed their minds before April 15. They decided they would rather include the distribution in income and pay tax on it. The taxpayer requested from the IRA custodian the return of the contribution plus earnings on April 10, 1990, and completed all of the necessary paperwork. The IRA custodian failed to make the distribution until May 11, which was well after April 15. The IRS argued that the distribution from the IRA should be included in income in 1990. This court decided that the distribution was taxable in 1989 because it found the statutory requirement was met by the taxpayer when he made his request and completed all of the necessary paperwork.

The United States Tax Court in the case of G. Richards and Sara B. Childs v. Commissioner of Internal Revenue considered the following situation. Sara was a participant in a state retirement fund. It was unclear whether a distribution from this fund qualified to be rolled over to an IRA. She originally thought it did, and so she rolled it over. Later, the plan advised her that they did not believe it qualified to be rolled over. She called the IRA custodian and directed its personnel to convert the IRA account into a non-IRA account. The IRA custodian did not honor the telephone request. The actual distribution to Sara was made in 1990, after the tax filing deadline for tax year 1989. Sara, however, included this distribution on her 1989 tax return. The IRS argued that the entire dis-

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Transferring an Inherited IRA — Permissible or Not

The IRS indicated such a transfer is permissible in four recent private letter rulings — PLR 9623037-040. These private letter rulings again illustrate that the IRS is going to permit the transfer of inherited IRAs from one IRA custodian to another in order to allow the IRA beneficiary to try to maximize earnings with a different IRA custodian.

The factual situation which is set forth below explains why there were four letters. Remember that a private letter ruling applies only to the taxpayer who requested it and cannot be cited by a third person as precedent.

An IRA accountholder established an IRA (IRA #1) in 1979 with IRA custodian #1. For discussion purposes we will assume the name of the accountholder is Jane Doe. Jane Doe was born on August 21, 1916. Her required beginning date was April 1, 1988. She designated her four daughters as her beneficiaries, each to receive an equal share. In 1991, Jane Doe

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Also in this issue –

FDIC Issues Advance Notice of Proposed Rule and Requests Suggestions

The Board of Directors of the Federal Deposit Insurance Corporation (FDIC) is seeking comment on whether the deposit insurance rules (insurance regulations) should be simplified, and if so, how. The Board seeks comments to see if new rules should be proposed and what should be the content or approach of any new rules. The FDIC discusses a number of specific proposals for simplifying the rules. However, the FDIC makes it clear that it will consider all suggestions. The FDIC states that it perceives the possible need for simpler rules because of its experience with numerous institutional failures and closures, the pass-through capital rules, and the numerous questions it is receiving. The FDIC intends to retain the primary concept that separate insurance coverage applies for different types of accounts which are owned in different ways (rights and capacity). The FDIC wants any commenter to address how any new proposed rules would impact the consumer and the banking industry.

The FDIC asks that you submit your comments so that they are received by the FDIC on or before August 20, 1996. You should address your written comments to the Office of Executive Secretary, Federal Deposit Insurance Corporation, 550 - 17th Street, NW, Washington, DC 20429. If you wish, you may hand deliver them to Room F-402, 1776 "F" Street NW, Washington, DC 20429 on business days between 8:30 a.m. and 5:00 p.m. Alternatively, you may fax your written response to 1-202-898-3838. The internet address is: comments@FDIC.gov

In its advance notice, the FDIC discusses seven possible ways to simplify its rules. However, only three of these proposed revisions apply to pension and IRA deposits. These three proposals are summarized below.

The first proposal is a generic recommendation. The rules would be rewritten to make them clearer and easier to understand. Part 330 of the regulation would be rearranged .

The second proposal would be to consider revision of the recordkeeping rule. The FDIC may like to be granted more discretion or flexibility in determining ownership of deposits held in a custodial or a fiduciary capacity. Current rules severely restrict the FDIC's ability to consider evidence outside the deposit account records of an insured institution in determining ownership of a deposit. That is, if the records clearly show ownership in a certain person's name (and not in a fiduciary capacity), then the FDIC possibly cannot look past this record and determine that there actually are owners other than the listed party.

The third proposal is to recommend to Congress that the FDI act (Federal Deposit Insurance Corporation Improvement Act of 1991) be amended to change the way employee benefit plans are insured. The FDIC believes the new rules are just too complex — both for the banking industry and for the public. As you will recall, pass-through insurance coverage is not available to employee benefit plan deposits if the accepting institution does not meet prescribed capital requirements. One major problem is: If a deposit is made at any institution without the prescribed capital, then there is a real disadvantage to the depositing plan but no real disadvantage to the institution. The FDIC proposes that the law be amended so that an institution not meeting the capital requirements could not accept the deposit. A simple rule would be one very similar to the rule which now governs the acceptance of brokered deposits. The FDIC wants to see how much public support they would have if they were to recommend this change to Congress. In 1991, Congress was quite proud of the new approach which they adopted — the degree of insurance coverage would be determined by the capital status of the financial institution. Congress may be reluctant to change this approach.

As with the IRS, it appears that the FDIC and other governmental agencies are actively seeking public comments as to how existing rules may be improved. PD

Summary of Three Bankruptcy Cases

Substantial assets are held in IRAs and pension plans. It is to be expected that creditors and bankruptcy trustees representing the interests of such creditors will want the funds in IRAs and qualified plans to be made available to pay debts. The problem is that ERISA contains specific provisions which generally protects the assets of a participant of a qualified plan from most every creditor except the Internal Revenue Service (IRS), and even, in some cases, the IRS. There is no federal law providing such protection for IRAs, but most states have laws protecting IRAs. The basic concept of bankruptcy law is to establish a system to allocate what money there is to liquidate existing debt (but not all debtors are given the same priority), and then to give the debtor a chance to start over.

This article summarizes three recent court cases which dealt with the bankruptcy topic .

The most important case is a recent U.S. Supreme Court case — U.S. v. Reorganized CF & I Fabricators of Utah, Inc. et al., U.S. Supreme Court, No. 95-325, decided June 20, 1996. Internal Revenue Code section 4971 imposes a 10% tax on any employer who has an accumulated funding deficiency with respect to its pension plan (defined benefit or money purchase plan). CF & I needed to make a $12.4 million contribution for 1989. It failed to make this contribution. The IRS assessed the 10% excise; the IRS was owed the amount of $1.24 million. CF & I filed under Chapter 11 of the Bankruptcy Code for reorganization. The IRS argued that this tax of $1.24 was entitled to priority status over various unsecured creditors because the section 4971 tax was an excise tax for purposes of bankruptcy law. The district court and the tenth circuit court of appeals ruled against the IRS. In fact, these courts even made the IRS claim rank below the claims of the unsecured creditors. The bottom line was that the IRS was not going to collect any of the $1.24 million it was owed. The IRS appealed to the Supreme Court.

The Supreme Court ruled that the term "excise tax" has a very specific meaning within the bankruptcy law. A tax for bankruptcy purposes must have the intent of raising money for the government. If the intent of the law is to penalize a party, then the assessment is not an excise tax for bankruptcy purposes but is a penalty. The government's priority to collect taxes under the Bankruptcy Code ranks higher than that of an unsecured creditor, but no priority is bestowed upon the collection of penalties.

The Supreme Court had no trouble finding that the 10% assessment on the accumulated funding deficiency was a penalty and not a tax. Thus, the IRS had no priority in relation to the other unsecured creditors. On the other hand, the Supreme Court ruled that the lower

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IRS Seminars on Magnetic/Electronic Filings of IRS Forms 1099, 5498, W-2G and 1042-S

The IRS issued Announcement 96-53 on June 17, 1996. It is set forth below. The IRS will be holding seminars in 13 cities to cover the latest magnetic/electronic filing of Forms 1099, 1098, 5498 and W-2G information, backup withholding and penalties relating to the filing of information returns.

Information Reporting Seminars

Representatives from the Martinsburg, Computing Center, Information Returns Branch, will conduct seminars in 13 cities during the months of August and September. They will cover the latest magnetic/electronic filing of Forms 1099, 1098, 5498, and W-2G information, backup withholding and penalties relating to the filing of information returns. A representative from Internal Revenue Service/International will discuss the filing of Form 1042-S.

Following is a schedule of seminar sites and dates, as well as the telephone numbers of the Internal Revenue Service offices closest to the sites. Please contact these Internal Revenue Service offices after July 22 for the exact location and times. **The agenda for the day has also been included for your convenience.**

1966 INFORMATION REPORTING SEMINARS

Sites	Dates	Telephone Numbers
Atlanta, GA	9/10-11	(404) 331-3808
Baltimore, MD	8/20	(410) 962-2402
Boston, MA	9/25	(617) 424-5310
Chicago, IL	9/24-25	(312) 886-1572
Cincinnati, OH	9/17-18	(513) 684-2828
Dallas, TX	8/27-28	(214) 767-3755
Denver, CO	8/29	(303) 446-1667
Los Angeles, CA	8/28-29	(304) 263-8700
Minneapolis, MN	9/26	(612) 290-3320
New York, NY	9/26	(212) 436-1023
Seattle, WA	8/27	(206) 220-5803
St. Louis, MO	9/19	(314) 539-2161
Tampa, FL	9/12	(904) 232-2514

1966 INFORMATION REPORTING SEMINARS

MORNING SESSION

IRS/MARTINSBURG COMPUTING CENTER

9:00 a.m.	Welcome
	Magnetic Media and Electronic Filing of Forms 1099, 1098, 5498 & W-2G
	Backup Withholding and Penalties

IRS/INTERNATIONAL

10:45 a.m.	Form 1042-S
12:00 p.m.	Lunch

AFTERNOON SESSION

SOCIAL SECURITY ADMINISTRATION

1:00 p.m.	W-2 Magnetic Media

Attention Paper Filers

The 1099/W-2 sessions are geared toward the magnetic media/electronic filer, and attendees should expect presentations to highlight that filing only. **No tax law representative will be present to answer questions.**

The Form 1042-S presentation will be structured to educate withholding agents on the special rules that apply to individuals who are not U.S. citizens or resident aliens, and how to report that information to the recipient and IRS. PD

Bankruptcy Cases—*Continued from page 2*

courts were wrong to say that the IRS' claim was to rank lower than that of the other unsecured creditors. The court found no authority for the other courts to place the IRS in a lower rank than the other creditors.

The second case is — In re: Howard Morten Harris, United States bankruptcy Court, Middle District of Florida, No 94-7386-9P7, September 27, 1995. This case is interesting because it raises the question: When can, or should, the bankruptcy court do the IRS' job and make a determination that a plan, which on its face was "qualified," was not actually qualified because there was clear evidence (at least to the judge) that the plan violated various pension laws? The law is well settled that any money in an ERISA qualified plan is exempt from creditors, including a bankruptcy trustee and bankruptcy judge. In this case the judge declined to follow a decision of the Fifth Circuit (Youngblood v. FDIC) that an IRS determination that a plan was qualified was not subject to review by the bankruptcy court. The debtor in this plan had been the sole shareholder of a professional corporation. The plan had a total of eight participants, including the debtor and his spouse. The IRS had issued this plan a favorable determination letter. This bankruptcy judge adopted the bankruptcy trustee's argument that the debtor, as trustee of the plan, had violated ERISA and so did not have a qualified plan because he had misused plan assets by making excessive loans to himself, had invested plan assets in properties for his exclusive benefit, and had made unwise investments. It will be interesting to see if this decision will survive the appeal process.

The third case dealt with Chapter 13 of the Bankruptcy code. The ruling from this case is quite technical, but it is still important. The case was — In re: Neil Solomon, M.D., United States Court of Appeals, Fourth Circuit, Nos. 94-2198 and 94-2263, October 23, 1995.

Under Chapter 13 the debtor may propose a plan to pay his or her creditors. Dr Solomon had been sued by three former patients. They were seeking millions in damages. He was age 62. At the time, he had an IRA with a fair market value of $1.4 million. Under Chapter 13, a debtor must calculate his "disposable income." Dr. Solomon calculated his disposable income and proposed to pay $45,000 over a term of five years. Dr. Solomon did not propose that he would take distributions from his IRA. The bankruptcy trustee and the creditors argued that the concept of disposable income required him to include distributions from his IRA. The appellate court disagreed since the term "disposable income" did not expressly cover IRAs. The appellate court made sure to point out that just because it had ruled that the law did not require an IRA distribution be included when determining disposable income, this did not mean that the lower court had to approve Dr. Solomon's proposed plan. Chapter 13 requires such a plan to be proposed in good faith. PD

Court Cases—*Continued from page 1*

tribution was taxable for 1990 tax purposes because she withdrew it after April 15, 1990. Sara argued that she had done her best to withdraw the funds before the tax filing deadline. Sara had been told by the IRA custodian's personnel that the conversion would be done, but then someone else overruled that person and said such act could not be done via telephone. No one informed Sara of this policy until after April 15. The court ruled that Sara was entitled to use Code section 408(d)(4) as she had done everything that could be reasonably expected to comply with this Code section.

These two cases illustrate the Tax Court's willingness to not apply the law literally when the IRA accountholder has done what was needed to comply with Code section 408(d)(4), but the IRA custodian did not carry out their responsibility in a timely manner. That is, the Tax Court has allowed the taxpayer relief from the IRS and not made the IRA accountholder seek legal redress from the IRA custodian. For that reason these two court cases are good news for financial institutions which serve as an IRA custodian. PD

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Inherited IRA—*Continued from page 1*

transferred this IRA to IRA custodian #2. Jane Doe died on February 2, 1995.

Jane Doe's four daughters have asked IRA custodian #2 to separate their mother's IRA into four separate shares — daughter #1 as beneficiary of Jane Doe, daughter #2 as beneficiary of Jane Doe, daughter #3 as beneficiary of Jane Doe, and daughter #4 as beneficiary of Jane Doe. After the creation of these four separate inherited accounts, each of the daughters has requested that her share/inherited account be transferred to IRA custodian #3. The daughters believe that they can maximize their respective investment returns by such a transfer. The daughters understand that the distribution schedule which must be continued after their mother's death is based upon the life expectancy of the oldest daughter.

The IRS ruled that the segregation of the four subaccounts did not affect the tax preferred status of the IRA and does not result in any taxation to each daughter. The IRS also ruled that any distribution from this segregated/inherited account will qualify as a distribution on account of death so the 10% excise tax under code section 72(t) will not be assessed. PD

✓✓✓ Check It Out ✓✓✓

Question. What is the best way for an IRA custodian/trustee to document a direct rollover?

✓ Answer. The IRA custodian/trustee wants to receive a copy of the QP distribution form (the section 402(f) notice) which the plan administrator furnished to your IRA customer. This form clearly indicates that the plan administrator had made the determination that the distribution qualifies to be rolled over. A rollover certification form should be used when the plan administrator's form is not available. The IRA custodian also wishes to keep a photocopy of the check.

Question. An IRA customer came to us on July 9th. He just realized that he had shown a $2,000 contribution on his 1995 tax return which he filed on February 17, 1996. He forgot to make his 1995 IRA contribution before April 15, 1996. What can he do?

Answer. It is not possible for him to make a contribution for tax year 1995 after April 15, 1996. He should file an amended tax return for 1995 and inform the IRS that he did not make the $2,000 contribution which he had previously indicated and pay any resulting taxes.

Question. An IRA customer has informed us that she heard that the 10% tax for distributions prior to age 59 1/2 will not apply to a distribution if she uses the funds to pay for college expenses or to make a down payment on her first house. Is she correct? have the rules changed?

✓ Answer. No, not yet. Congress is considering numerous proposals to change the IRA rules. Although in the last few years Congress has sent legislation to the President which would have changed the IRA rules, the President (both Bush and Clinton) have vetoed this proposed legislation for other reasons. Much discussion which takes place on television and radio does not clearly inform people of what rules are only proposed and not yet enacted.

Question. Is it true that all married couples who have adjusted gross income in excess of $50,000 are ineligible to make an IRA contribution?

✓ Answer. No. Remember that any person who does not attain age 70 1/2 or older during the year for which the contribution is made and who has compensation, is eligible to make a contribution equal to the lesser of $2,000 or 100% of compensation. This is true whether the person or couple is an active participant in a pension plan or not. A person's or a couple's adjusted gross income is important only to determine what portion of a contribution is deductible, and then only if one or both is an active participant in a pension plan.

Question. An IRA accountholder has indicated that he wishes to take one distribution today and then another one in 30 days. He wants and intends to roll over both distributions within 60 days of today's distribution. Will he comply with the once per year rollover rule?

✓ Answer. No. The rule is that an IRA accountholder is authorized by Internal Revenue Code section to roll over one distribution per twelve month period per IRA. The once-per-year limit applies to a "distribution."

Question. Are we, as an IRA custodian, required to send out TISA maturity notices with respect to our IRA time deposits?

✓ Answer. Yes. The Truth in Savings Act (TISA) applies to IRA deposits. This includes the TISA rules with respect to maturity notices.

Question. Our financial institution does not send out maturity notices because our IRAs are invested in variable paying accounts. Are we in compliance with TISA when we do this?

✓ Answer. Maybe. All variable paying accounts are not savings accounts. Some financial institutions have the mistaken impression that their variable paying account which allows for additional contributions, but also has a penalty for early surrender prior to a maturity date, is not subject to the TISA maturity notice rules. Savings accounts are not subject to the TISA maturity rules, but time deposit accounts are. In general, a savings account does not have a maturity date or a penalty for early surrender, but a time deposit account does have a maturity date and a penalty for an early surrender. Thus, if your institution charges a fee for the early surrender of the account, then your institution most likely should be furnishing the required maturity notice. However, it may be possible to draft a form so that the account is a savings account, but impose a fee on account of the "distribution" rather than the early surrender.

Question. We have an IRA accountholder, age 53, with a balance of $160,000. She wishes to establish a substantially equal periodic payment schedule. With an earnings rate of 6%, she would be entitled to use the amortization method to be paid the annual amount of $11,623.83 She only wishes to be paid annually the amount of $9,500. Should she establish one IRA or two IRAs.

✓ Answer. Two IRAs. This question illustrates a very important planning technique in any substantially equal periodic payment situation. As you know, the tax consequences are very harsh if for some reason the IRA accountholder would revise the schedule and take out more money than the schedule provided. An IRA accountholder can use the planning technique of having two IRAs rather than just one. The accountholder in this situation would put $130,775 (i.e. the amount needed to generate an annual payment of $9,500) in one IRA and the remainder of $29,225 in the second IRA. If she would need more money for some reason, she would take it from the second IRA. Only the distribution from the second IRA would be subject to the 10% excise tax. All previous distributions from the first IRA would not be subject to this tax. There is no reason to have more money in an IRA than is necessary to provide the required annual payment. PD

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