THE Pension Digest

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Budget Deal Includes IRA Changes

It appears very likely that the IRA rules will change in 1997.

On May 2, 1997, President Clinton, the Congressional leaders of the Republican party and the Congressional leaders of the Democratic party reached a compromise over a number of budget and tax issues.

The specifics may still need to be settled, but it does appear that these individuals were able to agree to the point that the ground rules have been established for future negotiations — they have defined the parameters of the negotiations by defining what "topics" will be included in the tax bills. The principal topics are: a cut in the capital gains tax rate, a cut in the estate tax, a tax credit for children, a tax credit for education, and IRAs.

The concepts of the President's proposed IRA changes are very similar to those summarized in prior newsletters. However, the changes are not quite as extensive as proposed in earlier years.

The Adjusted Gross Income (AGI) thresholds and the phaseout range would be gradually doubled from what they are today. For 1997-1999 the phaseout range for a single person would be AGI between $45,000 and $65,000. For 2000 and subsequent years the phaseout range for a single person would be AGI between $50,000 and $70,000. For 1997-1999 the phaseout range for a married couple filing a joint return would be AGI between $70,000 and $90,000. For 2000 and subsequent years the phaseout range for a married couple filing a joint return would be AGI between $80,000 and $100,000.

An IRA accountholder could withdraw funds from his or her IRA and not have to pay the pre-59 1/2 10% excise tax if the funds were used to pay post-secondary education costs, to build or buy a first home, or to cover living expenses if the person has been unemployed for at least 12 consecutive weeks.

A second "backloaded" type of IRA would be created. A taxpayer could choose between the two types of IRAs. As you will recall, the taxpayer receives no deduction for making the IRA contribution to a backloaded IRA, but there will be no taxation of the amount withdrawn from such an IRA as long as the contributions remained within the IRA for at least five years.

Summary

For years the politicians have been talking about restoring the right to take a tax deduction for IRA contributions. Because of the Budget Deal, it appears that this will finally happen in 1997, to a limited extent. Time will tell. PD

No Extension for IRA Contributions

The IRS' position is that it does not have authority to extend the IRA contribution deadline of April 15, even if disastrous floods, hurricanes, or tornados occur. This is true even though the IRS does have the authority to extend the deadline for filing the tax return.

Code section 219(f)(6) provides, "a taxpayer shall be deemed to have made a contribution to an IRA on the last day of the preceding taxable year if the contribution is made on account of such taxable year and is made not later than the time prescribed by law for filing the return for such taxable year (not including extensions thereof)."

The IRS does not believe it has the authority to change the rule of Code section 219(f)(6). Thus, any contributions made after April 15, 1997, will not qualify as a 1996 contribution unless the very rare situation occurs where the taxpayer has a taxable year other than a calendar year. PD

"We Are Proposing Changes to Your 199X Tax Return"

The IRS sends a five-page letter with this caption to numerous taxpayers each year. Based upon the information returns which have been sent to the IRS, the IRS believes the individual or couple owe more taxes than the tax return, as completed, indicates. The IRS' letter generally does a very good job explaining the IRS' position as to why the amount of tax owing should be increased. The IRS is not always right.

Set forth below is a very typical explanation for those taxpayers who have made an IRA contribution:

EXPLANATION OF CHANGES

IRA DEDUCTION ELIMINATED (FOR MARRIED TAXPAYERS WHO FILED A JOINT RETURN OR TAXPAYERS WHO FILED AS A QUALIFYING WIDOW(ER))

WE DIDN'T ALLOW YOUR DEDUCTION FOR IRA CONTRIBUTIONS BECAUSE YOU OR YOUR SPOUSE WERE COVERED BY A RETIREMENT PLAN AT WORK OR THROUGH SELF-EMPLOYMENT, AND YOUR 'MODIFIED ADJUSTED GROSS INCOME' IS MORE THAN $50,000 (THE LIMITATION AMOUNT FOR TAXPAYERS WHOSE TAX YEAR 1995 FILING STATUS IS MARRIED FILING JOINTLY OR QUALIFYING WIDOW(ER)).

ALSO COMPLETE FORM 8406, NONDEDUCTIBLE IRA CONTRIBUTIONS, IRA BASIS, AND NONTAXABLE IRA DISTRIBUTIONS, TO KEEP FOR YOUR

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RECORDS SO YOUR FUTURE NONDEDUCTIBLE CONTRIBUTIONS WILL BE CORRECT.

The purpose of this article is to make the following observation: The IRS makes clear that the contribution which the taxpayer(s) thought was deductible must be treated as a nondeductible contribution. There is no indication in this five-page letter that the IRS will allow the withdrawal of this contribution as the withdrawal of an excess so that the pro rata taxation rules would not be used to calculate the taxable portion of the distribution. In another paragraph in the letter, the IRS states that the taxpayer need not file an amended return with the IRS as long as he or she agrees with the IRS' changes. He or she should complete a Form 8606 (Basis for Nondeductible Contributions), so he or she would have it for his or her records. The IRS does remind people that it shares information with state and local tax entities. So if this change affects a state or local tax return, the person should file an amended return with such state or local tax entity.

Reminder – An IRA Beneficiary Is Not Eligible to Roll Over an Inherited IRA

Code section 408(d)(3)(C) provides that a beneficiary of an inherited IRA is not eligible to roll over the inherited IRA funds into another IRA, be it a regular IRA or an inherited IRA.

The practical importance of this rule is — when a beneficiary takes a distribution from an inherited IRA, the beneficiary should understand that this distribution will be included in his or her income and that there is no way to "undo" the distribution once it takes place. Illustration — Tom Walsh inherits his mother's IRA which has a value of $86,000. Tom's mother was age 68 when she died. Tom has a friend who is a broker. This friend tells Tom that he should bring this $86,000 to him and he will help him reinvest it. Tom walks into your institution and withdraws the $86,000. The check is made payable to him. He thinks he will just walk it over to the broker. Tom has made a horrible error with severe tax consequences. He will have to include this $86,000 in his income and he will not be able to roll over any portion of it. If he would try to do so, he would have an excess contribution.

Although a beneficiary may not move the funds from one IRA custodian/trustee to another by a rollover, this type of movement may take place via transfer. An IRA custodian/trustee should use a special administrative form when an inherited IRA is transferred. This is true whether your financial institution is the accepting or the remitting institution. A sample is enclosed of a "Transfer of Inherited IRA Form."

Guidance for Completing MSA Form 8851

A financial institution which serves as a Medical Savings Account (MSA) custodian or trustee must file the Form 8851 (Summary of Medical Savings Accounts) by June 2, 1997, to report certain information about those MSAs which were established from January 1, 1997, through April 30, 1997.

As with other IRS reporting forms, you can use paper forms if you have less than 250 MSAs. You would send these forms to the Internal Revenue Service Center, Philadelphia, PA 19255. If you have more than 250 MSAs, you must file on magnetic media or electronically. If you file magnetically or electronically, you must still complete that portion of the Form 8851 above line "a" (i.e. the trustee's information) and send it to the Internal Revenue Service, PO Box 879, Kearneyville, WV 25430.

Be aware that you will need to file another Form 8851 by August 1, 1997, to report MSAs established from May 1, 1997, through June 30, 1997.

The Form 8851 was previously included in the March issue of the *The Pension Digest*. The IRS has designed Form 8851 with the goal of determining the number of MSAs which have been established which will count against the maximum limits which are set forth in the law – 375,000; 525,000; 600,000 and 750,000, and to also determine the number of MSAs which have been established which will NOT count against the numerical limits. This information will also be used by Congress to determine if MSAs should be expanded or curtailed.

As discussed below, there are two types of MSAs which will not be counted to determine if the numerical limits have been exceeded. First, the MSAs of a person who was previously uninsured will not be counted. Second, the MSAs of certain married couples will be counted as one MSA rather than being counted as two MSAs for purposes of the numerical limits.

An MSA custodian/trustee is required to furnish the IRS with the following information:

1. The names and social security numbers of each MSA accountholder;

2. The total number of MSAs you established during the reporting period.

3. The total number of previously uninsured accountholders; and

4. The total number of excludable accountholders.

Note that even though the IRS does not expressly ask for it — the IRS can also determine those accountholders who are neither previously uninsured or excludable. That is, the number of total MSAs, less those previously uninsured, less those excludable, will give the number of those MSAs which are neither previously uninsured nor excludable.

You will have no problem understanding what is meant by names, social security numbers, and total number of MSAs because these are easily defined and understood.

Such is not the case for the terms, "previously uninsured" or "excludable."

By definition, a person who establishes an MSA must be covered under a high-deductible health plan (HDHP). This person could have either self-only coverage or family coverage.

An MSA accountholder with self-only coverage will be considered to be previously uninsured if he or she had no health plan coverage at any time during the six-month period before coverage under the HDHP began, and HDHP coverage must not have begun before July 1, 1996.

An MSA accountholder with family coverage will be considered to be previously uninsured if both the accountholder and his or her spouse had no health plan coverage at any time during the six-month period before coverage under the HDHP began, and HDHP coverage must not have begun before July 1, 1996.

Remember that "permitted" insurance and coverage for accidents, disability, dental care, vision care or long-term care will not make the person ineligible for the MSA. Permitted insurance is defined to be: medicare supplemental insurance; insurance if substantially all of the coverage which is provided under such insurance relates to workers compensation, tort liabilities, or property insurance; insurance for a specified disease or illness and insurance paying a fixed amount per day or other period of hospitalization.

The number in the previously uninsured column will NOT count against the statutory limits.

The instructions make clear that a person who is "previously uninsured" will not be "excludable" or vice versa.

It is not as clear what is meant by the term "excludable accountholders." Again, the number in this column (those excludable) will NOT count against the statutory limits.

The IRS instructions contain a definition of who is excludable. This definition is murky. We have paraphrased the definition as follows: "An accountholder who is not considered previously uninsured will be considered an excludable accountholder when he or she opens an MSA if his or her spouse has, or had, an MSA and also was not considered previously uninsured."

Why? The MSA of the spouse who first established his or her IRA would have had it counted because it would not have been excludable. The IRS instructions cover the special situation as to what happens if a married couple simultaneously open MSAs and neither is considered previously uninsured. The result is — one of the spouses, but not

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Form 8851—*Continued from page 2*

both, is to be treated as an excludable accountholder.

Why Is There a Special Rule for Married Persons?

Code section 220(j)(4)(D) provides that to the extent practicable, in determining the number of MSAs and whether or not they will count against the numerical limits, all MSAs of a person are to be aggregated (i.e. treated as one account) and all accounts of married persons are to be aggregated (i.e. will be treated as one account).

The concept is — if there is a married couple who both previously had insurance (i.e. both were not previously uninsured), then their two MSAs shall be aggregated and only "one" will count against the statutory limits.

Note, if both spouses were previously uninsured, then both MSAs would be excluded for that reason and not because of the special "marriage" rule.

The Form 8851, as designed, will allow the IRS to determine if a person has more than one MSA with different MSA custodians because the IRS is furnished the name and social security number of each accountholder. The only way the "marriage" aggregation issue is handled is by the "excludable" column.

In summary, an MSA custodian/trustee must file the first Form 8851 by June 2, 1997, and the second Form 8851 by August 1, 1997.

Court Cases of Interest

FDIC Coverage of IRAs

An IRA accountholder had invested $355,000 in an IRA money market fund with a certain bank. This bank was declared insolvent by the FDIC. The FDIC paid the insured amount of $100,000. The accountholder then filed a claim for the remaining amount of $255,000. The FDIC only paid the amount of $119,946 (a pro rata portion). Thus, the accountholder lost $135,258.

The IRA accountholder started this case and argued he was entitled to be paid the entire $255,000 because an IRA was a special deposit under California law because of the IRA plan agreement's nonforfeitable provision and thus it was entitled to priority status versus the non-IRA depositors of the bank.

The court concluded otherwise. The nonforfeitable provision certainly limits a bank from offsetting a defaulted debt against the IRA funds, but this provision does not provide any special preference in an insolvency situation versus other depositors of the bank.

This case was Howard S. Goldblatta v. Federal Deposit Insurance Corporation (U.S. Appeals, 9th Cir. 2-3-97).

A Failed Rollover — The Case of the Foreign IRA

IRA accountholders who move out of the United States need to remember that federal law requires that an IRA custodial or trust account must be created and maintained in the United States.

In this case, an IRA accountholder withdrew his funds from the U.S. bank where he had established his IRA. He redeposited them into a bank in Hong Kong. This person failed to include this distribution on his tax return and so he failed to pay taxes on this amount, including the 10% pre-59 1/2 excise tax.

The IRS argued, and the tax court agreed, that he did not establish an IRA with the Hong Kong bank because such bank was not legally authorized to render IRA services because it was not located in the United States. The IRA accountholder then tried to argue that since the Hong Kong bank owned a U.S. bank, that should be sufficient. It was not.

To have a valid IRA, an IRA plan agreement/trust must have a situs in the United States, and what determines this situs of the trust is the location of the bank.

Observation: a person can certainly establish an IRA with a U.S. Bank and then have investments in "foreign" entities, but the IRA must be created with a bank located in the United States.

This case was Davie W. Chiu v. Commissioner, U.S. Tax Court, No. 5197-95, T.C. Memo 1997-199, April 30, 1997.

A Failed Spousal Waiver

The Retirement Equity Act of 1984 changed the law to create specific protections for spouses of certain qualified plan participants. The case discussed below illustrates very clearly that there are going to be undesired results (and liability) if there is not strict compliance with the "spousal consent" rules.

The case is Lasche vs. George W. Lasche Basic Profit Sharing Plan, CA 11, No. 96-427, 5/6/97.

ERISA, as amended, very clearly requires that a spousal waiver of retirement plan benefits and certain designations of beneficiaries be witnesses by a "plan representative or notary public."

The facts are these. George Lasche and Madeline Baker signed a pre-nuptial agreement in 1985 before they were married, wherein each waived any rights to the other's property. After being married, they amended the prenuptial agreement by expressly waiving any interest in retirement plans and promising to sign any needed administrative forms. Later, Mr. Lasche transferred his Keogh account to Merrill Lynch. In so doing, Merrill Lynch furnished him a form to designate his beneficiaries. He named his three daughters from a previous marriage. Madeline signed that portion of the form indicating her consent. That same portion of the form contained the provision or space where the plan administrator or notary public could sign as a witness to the consenting spouse's signature. This section was left blank. George Lasche did sign the form in another section as the plan administrator, but not in this section. Madeline argued that her attempted waiver was not successful and that she was entitled to receive George's pension account balance as she was the designated beneficiary because her attempted waiver was defective. The court agreed.

Comment: We have recommended for a long time that in the case of a one-person plan, it is better if an independent notary public witness the spouse's signature and not the participant spouse as plan administrator.

Three Anti-Alienation (Creditor) Cases

Internal Revenue Code section 401(a)(13) states that a trust will not be qualified unless it provides that benefits provided under the plan may not be assigned or alienated. ERISA section 206(d)(1) provides a similar rule.

The rule to date has been that as long as funds are within the plan (i.e. have not been distributed to the participant) that creditors (other than the IRS) cannot levy, attach, execute or reach such assets to satisfy debts or judgments.

Case #1. In this recent case, a creditor tested the above rule and lost.

An individual with substantial judgments against him had requested a distribution from the pension plan of which he was a participant. The plan administrator prepared the check listing the participant as the payee. The check had been furnished to the trustee for distribution to the participant. Before the check could be furnished to the participant, some creditors furnished the trustee with a writ of attachment. They wanted to force the trustee to turn over the check to them. The court, not surprisingly, ruled that a distribution had not yet taken place, as the participant did not have possession of the check. The funds were still within the qualified plan, and the writ of attachment did not need to be honored. See James P. Shinehouse v. James H. Guerin, U.S. Appeals, 3 Cir., unpublished Jan. 1997).

Case #2. An individual filed for bankruptcy.

The U.S. Court of Appeals for the Seventh Circuit has rules that this person's pension account balance is exempt from creditors (i.e. the bank) and the bankruptcy trustee even though he impermissibly used money from his own pension account to try to rescue his business. Except for the IRS, creditors just cannot reach assets within pension plans because of the anti-alienation laws.

Case #3.

The United States Court of Appeals, District of Columbia, in Roberts and Lloyd, Inc. v. Betty R. Zyblut, No. 94-CV-1215, March 20, 1997 reversed the decision of the trial court and ruled that a Keogh account is not exempt from creditors because a one-person pension plan is not protected by ERISA.

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Discussion of 1996 Form 5500-EZ and Schedule P

Who Uses the Form 5500-EZ?

The Form 5500-EZ can be used for a one-person retirement plan if the person sponsoring the plan meets all of the following conditions:

1. The plan is a one-participant plan. If the sponsoring business is a sole proprietorship, then the plan may cover only the owner of the business and his or her spouse. If the sponsoring business is a partnership, then the plan may cover only one or more partners (and spouses).

2. The plan meets the section 410(b) coverage rules without having to be combined with any other plan sponsored by the same sponsor.

3. The plan does not provide benefits for anyone who is not a participant.

4. The plan does not cover a business that is a member of a group of businesses as under common control, a controlled group of corporations or an affiliated service group.

5. The plan does not cover a business which leases employees.

If all five of these conditions are not met, then the sponsoring business must file the Form 5500-C/R.

Who Does Not Need to File the Form 5500-EZ or the Form 5500-C/R?

No filing is necessary if the plan sponsor meets the five requirements listed above and if the plan sponsor had one or more plans that had total plan assets of $100,000 or less at the end of every plan year ending after January 1, 1994.

Which One-Participant Plans Must File the Form 5500-EZ?

A one-participant plan must file the Form 5500-EZ if the plan sponsor had one or more plans that had total combined plan assets of more than $100,000 at the end of any plan year ending after January 1, 1994.

A one-participant plan which is required to file the Form 5500-EZ must complete and file it for the first year which is required and then for every year thereafter. That is, it is no longer possible to file a Form 5500-EZ and then not file one for the next year.

A special rule applies to terminating plans. All one-participant plans must file a Form 5500-EZ for their final plan year even if total plan assets have always been less than $100,000. The final plan year is the year in which distribution of all plan assets is completed.

Changes in Filing Rules Summarized

For 1994 and prior years, one-participant plans that held $100,000 or less in total plan assets at the end of any plan year did not have to file the Form 5500-EZ (or any other information return) for that plan year. For 1995 and later years, one-participant plans that held more than $100,000 at the end of any plan year beginning on or after January 1, 1994, must file a Form 5500-EZ for the year the assets exceeded $100,000 and for each year thereafter, even if total plan assets were reduced to $100,000 or less at a later date. For example, if plan assets in a plan that otherwise satisfies the requirements for filing the Form 5500-EZ totaled $110,000 at the end of the 1994 plan year, and a distribution occurred in 1995 so that total plan assets were $85,000 at the end of the 1995 plan year, a Form 5500-EZ must be filed for the 1995 plan year.

Penalties for Failing to File

The IRS imposes a penalty of $25 a day (up to $15,000) for not filing this form.

Where to File

This form is filed with the IRS Service Center in Memphis, Tennessee 37501-0024.

Filing Deadline

For most people, the deadline is July 31, 1997. Technically, the deadline is the last day of the seventh month following the end of the plan year. It is possible to obtain an extension by filing Form 5558. A 2 1/2 month extension may be obtained.

Explanation

The IRS has furnished a sample and a supplemental explanation. These are set forth on the enclosure along with the Schedule P. The 1996 form is very similar to the previous years' forms. Most items on the form are self-explanatory. But here are a few comments for those "newer" items.

1. Line 4(a). The person must furnish the opinion letter number which the IRS has issued to the financial institution if the person is using an institution's prototype. This is an audit question. If the institution has an "old" prototype (i.e. one with an opinion letter before June of 1990), the IRS will be contacting the person. Remember, plans must be updated in a timely fashion by both the institution sponsoring the prototype and also by the business person. The institution must update its prototype, and the customer must timely adopt this updated prototype.

2. Line 4(b) asks if this plan covers self-employed persons, partners or a 100% owner of a corporation. The IRS wants to be able to determine to which of these categories the person belongs.

3. Line 7(a), about fully-insured plans, will not apply to most plan sponsors unless they have established the plan with an insurance company.

4. Line 7(b) and 7(c) deal with contributions. Plan contributions should be in cash. Question 7(c) is asking if there were any noncash contributions (an audit question).

5. Line 7(d) asks for the amount of plan distributions to participants or beneficiaries. This includes amounts rolled over whether by use of Code section 401(a)(31) or not. If the plan distributes an asset other than cash, include the current value (i.e. fair market value) at the time of distribution. However, when an annuity or an insurance contract is distributed, insert the cash value at the time of distribution.

6. Line 7(e) asks for the amount of those distributions which are nontaxable. Examples would be — the return of non-deductible employee contributions, and payments which qualify for the death-benefit exclusion.

7. Line 7(f) asks for the amount of transfers to other plans. The IRS means "transfers" under Code section 414(l) and not direct rollovers which are treated as distributions.

8. Line 7(g) asks for the amounts received by the plan for reasons other than the standard employer contributions. Examples are – rollover contributions, direct rollover contributions, transfers and the receipt of earnings on plan investments.

9. Line 10 asks if there are other employees. Having additional employees is not necessarily a sign the plan sponsor is doing anything wrong. The IRS might check later to see if the plan sponsor has covered this employee properly.

10. Line 11(b) asks if there were any distributions in a form other than a QJSA (qualified joint and survivor annuity). The form of payment must be a QJSA unless special waivers are executed or the plan is a profit-sharing plan which is not subject to the QJSA rules. Many people will need to answer this question "yes." Example, a person was paid a lump-sum distribution from a profit-sharing plan; a person was paid a lump-sum distribution from a money-purchase plan after receiving the spouse's waiver; a person was paid a partial distribution from a profit-sharing plan; or a person was paid a partial distribution from a money-purchase plan after receiving the spouse's waiver.

11. Line 11(c) asks if there were any loans to married participants. Although most people with profit-sharing and money-purchase Keoghs understand that they themselves cannot borrow from their plan, sometimes they are unaware that they cannot make loans to their spouses.

Summary

The filing requirements for the 1996 Form 5500-EZ have changed very little from 1995. If your financial institution does not assist with the preparation of the Form 5500-EZ, then we would suggest you send a reminder notice to your business customer that he or she will need to determine if the 1996 Form 5500-EZ must be filed. The IRS still takes the position that the Schedule P may only be filed as an attachment to the Form 5500-EZ, and it may not be filed separately. And remember, those employers with more than one participant are required to file either the Form 5500-C/R or Form 5500. PD

Court Cases—*Continued from page 3*

Comment

Many pension commentators would agree with this decision. Others would not for the following reason. Both ERISA and the Internal Revenue Code require that funds not be subject to creditors. Code section 401(a)(13) is a requirement of the Internal Revenue Code and not ERISA. In order to have a Keogh plan document, that Keogh plan document must contain the restriction that the funds may not be assigned or alienated. Whether this Keogh plan is a pension plan for ERISA purposes should be irrelevant. This issue will certainly be litigated in other Circuit Courts and then the conflict between the Circuits will need to be decided by the Supreme Court. PD