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RMDs

Rollovers and Transfers

Confusion reigns as to whether or not an IRA accountholder or beneficiary, who is subject to the required minimum distribution rules (RMD), is eligible to roll over or transfer his or her RMD. The purpose of this article is to discuss the procedures we recommend using until the IRS clarifies the rules. We at Collin W. Fritz and Associates, Ltd. have recently written the IRS and asked them to clarify the rules.

In 1987, the IRS issued proposed regulation 1.401(a)(9) and 1.408-8. These proposed regulations state quite clearly the rule that an RMD could not be transferred, and if a transfer occurred, that the 50% excise tax would be owing. Similarly, the proposed regulation indicated that an RMD was not eligible to be rolled over, and if such a rollover took place, it would most likely be an excess contribution. The approach of the proposed regulation was, and is, there needs to be an RMD from each qualified plan or IRA. This "each plan" rule certainly leads to the "no transfer or rollover" rule.

With respect to rollovers, the IRS had little choice but to write the RMD rules as it did within the proposed regulation. Internal Revenue Code section 408(d)(3)(E) states that RMD distributions are not eligible to be rolled over.

With respect to transfers, the IRS had more choices for developing RMD rules. There is no statute which authorizes transfers or, for that matter defines them. The IRS has "administratively" created the concept of transfers. Presumably, the IRS wished to adopt a consistent and logical approach between rollovers and transfers. Therefore, the IRS, in the proposed regulation, adopted the approach that an RMD amount could not be transferred, just as it could not be rolled over. If it was transferred, the proposed regulation stated the 50% excise tax was owing. This is a harsh result.

In 1988, the IRS issued Notice 88-38. In this Notice, the IRS adopted the rule that an IRA accountholder was still required to calculate his RMD for each IRA plan separately, but could then aggregate the individual RMD amounts and take a distribution of the aggregate amount from just one IRA account. This approach was, and is, only for IRAs. It does not apply to qualified plans. This Notice was originally intended to apply only to the 1988 tax year, but was unofficially extended by the IRS in 1992 when they incorporated it into their Model IRA forms and their prototype programs. As such, this approach is still valid for IRAs. The problem this Notice created relates to the rollover and transfer situations. How, and does, this Notice apply when a transfer or rollover is occurring when the accountholder is in RMD status?

We hear time and time again that transfers and rollovers are coming to institutions when no RMD was taken from the distributing IRA. Is this permissible? Many custodian/trustees of IRAs feel that Notice 88-38 means that the accountholder can choose to take their RMD from another IRA and transfer or roll over the RMD from the distributing IRA to another IRA. As it appears that many institutions are relying on this concept, we asked the IRS whether or not this would be permissible. The IRS, as stated earlier, responded to some of our questions but not all. The IRS written response states that Notice 88-38 has no impact on the general rule that an RMD cannot be rolled over. They went on, however, to state the following, "If an individual rolls over a distribution from an IRA that made no actual required minimum distribution (the requirement having been satisfied from other IRAs), the rollover will not be considered a rollover of a required minimum distribution." This means that if the accountholder has already taken sufficient distributions to satisfy their RMD requirement for the year, a rollover from an IRA from which no distributions were made is permissible. The key words are "has already taken." Nothing in the IRS letter indicates that the accountholder could make the rollover and take the RMD after the rollover was made. Rather, the letter indicates that the distribution must have been made in order for the rollover to be permissible.

The IRS did not offer any meaningful response to our posed question as to how the RMD transfer rules as set forth in the proposed regulation were affected, if at all, by Notice 88-38. The only comment from the IRS was, "Note that Q&A C-3 states that a transfer is not a distribution, so that amounts transferred are not treated as having been distributed and rolled over." Not much help.

You, as an IRA custodian, must decide what your RMD transfer procedures will be. Your possible options are:

1. Apply the RMD rules of the proposed regulation as not being changed by Notice 88-38.

This means if you are the transmitting IRA custodian, then you require that the RMD be distributed to the IRA accountholder or beneficiary prior to any transfer, or that the RMD amount be left on deposit for distribution later in the year.

This means if you are the receiving IRA custodian, then you do not accept any transfer amount which includes an RMD amount. That is, you must confirm that the RMD has been distributed from this IRA before you will accept the transfer.

2. Apply the RMD rules of the proposed regulation as modified by Notice 88-38 as follows.

Transfers are permissible if the IRA accountholder or beneficiary certifies that he or she has already satisfied the RMD amount for this IRA (and all other IRAs) by having

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taken his or her RMD by taking a distribution from a different IRA(s).

The thought is that the IRS very likely will adopt a rule for transfers which is very similar to the rule which they stated for rollovers.

Both the transferring and the receiving IRA custodian need to be furnished a certification that the RMD requirement was met from a different IRA or IRAs.

Note that this method does not permit the IRA accountholder or beneficiary to adopt the approach, "I will just take my RMD later in the year by the applicable deadline, December 31 or April 1." Many RMD IRA accountholders feel they should be able to wait and take the distribution by the "normal" deadline and that their transfer should not affect this deadline.

3. Apply the RMD rules of the proposed regulation as modified by Notice 88-38 as follows.

Transfers are permissible if the IRA accountholder or beneficiary certifies that he or she will take the RMD amount with respect to the IRA being transferred from the receiving IRA or a different one on or before the applicable deadline.

Some commentators have argued that the receiving IRA is a different IRA for purposes of Notice 88-38 and so the distribution may be taken from the receiving IRA later in the year.

Recommended Procedure

Until the IRS states in writing how the RMD rules are affected by the rule of Notice 88-38, an IRA custodian/trustee must decide between option #1 and option #2. Option #3 should not be used at this time except in a very limited fashion as discussed below.

Option #1 is certainly the most conservative approach. We at CWF have written our administrative forms according to this approach. We would expect, though, that when the IRS ultimately writes its position, it will adopt the approach of option #2. We recommend that an IRA custodian who adopts option #2 implement a procedure to have the IRA accountholder or beneficiary furnish it with a certification that the RMD has been taken (not will be taken) from a different IRA.

For those IRA accountholders or beneficiaries who believe that option #3 is permissible, you need to decide if you will accommodate them or not. They have heard from different advisors or the other financial institution that it is permissible to transfer the RMD and take this amount later in the year. We would not recommend this be an institution's standard procedure. We would see this procedure being used in limited cases — an irate customer who just believes he or she can do it. If you do accommodate an IRA accountholder or beneficiary, then at a minimum you should require that they furnish you with a certification that they have been informed of the various rules and unsettled issues, and that if the IRS would not accept the approach of option #3, the 50% excise tax would be owed by them and that they agree to hold you, the IRA custodian, harmless.

Practical Problem #1

What should you do when a transfer has been sent to your institution and you know that the RMD for the current year has not been distributed, and it has been transferred to you? The most conservative approach is to return the check and ask for the transfer or check to be for the net amount (gross less RMD amount). A less conservative approach is to deposit the entire check and then immediately distribute the RMD amount. In this case, you should inform the IRA accountholder that the IRS could, under the proposed regulation, assess the 50% excise tax. Most likely the individual could convince the IRS that they had a reasonable explanation (the other institution erred in transferring the entire amount) and therefore they should not have to pay the 50% excise tax, but you cannot guarantee that this would be the IRS' response.

Practical Problem #2

When an IRA custodian receives a transfer, it generally believes that there has not been a transfer of any RMD amount. Sometimes you find out later that an RMD amount has been transferred. You should use the same approach discussed above. You should immediately distribute the RMD amount. Again, you should inform the IRA accountholder that the IRS could, under the proposed regulation, assess the 50% excise. Most likely the individual could convince the IRS that they had a reasonable explanation (the other institution erred in transferring the entire amount) and therefore they should not have to pay the 50% excise tax, but you cannot guarantee that this would be the IRS' response.

Note: We are often asked the question concerning the application of the RMD rules in a death situation. It is common practice for data processing purposes to "transfer" funds from a deceased accountholder's IRA to an inherited IRA on behalf of the beneficiary. For example, the title of the inherited IRA becomes, "Ann Smith's IRA as beneficiary of John Smith."The following question is frequently asked, "Must the current year's RMD, if applicable, be distributed before the funds may be transferred from the decedent's IRA to the inherited IRA?"

The answer is "no." This movement of funds is an internal transaction and is done so the IRA custodian/trustee may accomplish its governmental reporting tasks. This movement of funds is not a transfer in the technical sense of the term. An IRA transfer occurs when funds are moved from one IRA plan agreement/custodian to another IRA plan agreement/custodian. In the death situation, the IRA of the decedent by operation of law, becomes the inherited IRA of the beneficiary.

Example: John Smith is age 78. His RMD amount for 1997 is $2,550. His account balance was $48,960 on December 31, 1996. His beneficiary is his daughter Ann Smith, age 48. He died on March 13, 1997. His RMD had not been paid to him and has not been paid to Ann yet. The IRA custodian is now in the process of establishing the inherited IRA for Ann Smith on its computer system. Must Ann Smith be paid the $2,550 before the creation of the inherieted IRA (i.e. a type of transfer) or can she wait and receive this distribution later, but before December 31, 1997? She can wait; again, this type of movement of funds is not a transfer subject to the RMD transfer rules.

Summary

An IRA custodian must adopt procedures to process rollovers and transfers coming from or to the IRAs of your accountholders who are subject to the required minimum distribution rules. This encompasses both IRA accountholders who are age 70 1/2 and older, and beneficiaries. As with other IRA administrative topics, the rules are more unclear than is desired because the IRS has not given the clear guidance they maybe should have. The IRS has for some time listed its desire to issue some changes or modifications to the RMD proposed regulations. The problem has been that they have other more important tasks arising from the 1996 law changes. The IRS will most likely not have the time over the next 6 to 18 months either, because of the expected 1997 law changes. PD

Reminder

Phone Numbers on IRS Reporting Form

The IRS has issued Announcement 97-60 to remind payors, i.e. financial institutions, that the phone number of a person they can contact at the institution with questions about the report must be included on the form. This applies to the Forms 1099-R and 5498 for the 1997 reporting year. On the actual IRS forms, this information is included in the payor section of the form. On a substitute form, the Announcement states that the phone number can be placed in any conspicuous location on the form. Do not forget to include this information this year. PD

Medical Savings Accounts – The Use of Debit Cards and Checking Accounts

The new Medical Savings Accounts (MSAs) were created for use by individuals who have high-deductible health care plans. The MSA deposit vehicle was intended to be used to accumulate the funds necessary to pay medical expenses that the high-deductible health care plan does not cover because the accountholder has not yet met the health care plan's deductible limits. The nature of the MSA then is one of being a transaction type of account. In many cases individuals will be making monthly contributions to the MSA. They will also be taking distributions from the account as medical expenses are incurred. This means deposits and withdrawals could be occurring on a fairly frequent basis.

Many institutions that are offering MSAs are doing so by using a debit card and a related savings account, or an account that offers check-writing features as the deposit vehicles. While there is nothing in the MSA rules that prevent this, care needs to be taken when using these types of accounts as the MSA investment vehicle. Both approaches will be looked at in this article, and some of the potential problem areas discussed.

Use of a checking account or some type of savings instrument that provides check-writing capability with an MSA does raise some potential problems. The major concern with the use of an account that has check-writing features is what would occur if the accountholder were to write a check on the account when there were not sufficient funds in the account to cover the withdrawal. The potential problem arises with the difference between an "overdraft" and a check that is not honored and is returned for reason of "non-sufficient funds" (NSF). Many institutions do not return checks that overdraw the account. The customer may be a good customer that the institution knows will deposit the funds necessary to cover the overdraft or may have some arrangement with the institution to cover overdrawn accounts up to some point. This type of arrangement would not be permissible with an MSA. There can be no overdraft protection or privileges granted to an MSA account. The primary reason for this arises under a fairly complicated set of rules called the "prohibited transaction"rules. These rules have been discussed many times in this newsletter in the past. It is very clear that these rules apply to MSAs. They apply in the same manner to an MSA as they do to IRAs. This means that if a prohibited transaction were to occur in an MSA, the MSA is deemed disqualified as of the first day of the year the prohibited transaction occurs. Should an institution allow an MSA with checking account features to be overdrawn, a prohibited transaction has occurred. The institution, as custodian or trustee of the MSA, is a disqualified party under IRC 4975. This Code section explicitly prohibits loans between a disqualified party and the account. By allowing an overdraft, the institution has in essence made a loan to the MSA. A prohibited transaction is the result. The MSA would be deemed disqualified as of the first day of that year. This means that the entire balance as of that date is considered taxable income to the individual. This is the result because the MSA rules state that any distribution deemed made under prohibited transaction rules is considered to be a non-medical reason distribution. As such, income tax and potentially the 15% premature distribution penalty tax would apply. The bottom line is that MSA overdrafts cannot be covered. The institution must not honor the check and must return it NSF. The institution's personnel and the accountholder need to be made aware of this policy and the special nature of this account.

If an accountholder did overdraft the account and the check was returned by the institution, could the accountholder deposit funds and reissue the check? The answer would depend on the contribution rules for MSAs and the contributions that had occurred in that year. If the accountholder had made the maximum contributions allowed for that year, the answer is clearly "No." A contribution could not be made to cover this check. If, on the other hand, the accountholder was still eligible to make further contributions, it would seem to us that the contributions necessary, up to the annual limit for the individual, could be made to cover this check. These contributions must be made as soon as possible.

Debit cards, by their nature, should not present the overdraft problems found with checking accounts. The major problem here would be the unauthorized use or misuse of a debit card tied to an MSA.

The unauthorized use of a debit card would obviously occur if someone other than the accountholder or the accountholder's family members, who were approved to use the card, were to obtain the card and use it. Obviously a distribution has occurred. Most debit cards, however, have a protection feature that states if the issuer is notified of a loss or theft of the card within a specified time period, the issuer will cover some or all of any of the unauthorized uses of the card. While the rules do not address this issue, it would seem to us that the possibility of a prohibited transaction again exists. It is possible that the IRS would deem this a prohibited loan similar to what was discussed for checking accounts. We do not know for sure that this would be the result, but the possibility is there.

Misuse of the debit card could also occur, especially in situations where the accountholder authorized the issuance of more than one card tied to the MSA. A family member could very well use the card for nonmedical reasons, in which case the amount of that transaction would be taxable income to the accountholder and also possibly subject to the 15% premature distribution penalty tax. While this situation is really not the institution's concern, it is one that the accountholder should be made aware of.

While it may appear from this discussion that we do not feel these vehicles should be used with MSAs, that is not the case. Use of a debit card or an account with check writing features is probably one of the easiest and most convenient ways for the institution to offer and administer MSAs. What we are saying is that when these types of vehicles are used, care and caution need to be exercised. The accountholder should be made aware of these types of issues, and the financial institution's personnel need to know these accounts are special in nature and need to be handled with care. PD

IRS Information Seminars

The IRS has announced that it will be holding seminars around the country dealing with information reporting. The seminars will cover magnetic media reporting changes for 1997 and changes to record layouts for this year relating to three new forms, the 1099-MSA, the 5498-MSA, and the 1099-LTC. The seminars will also cover layout changes to other forms, test files, corrections, replacement files, combined federal/state filing, and backup withholding and penalties. The seminars relate to information reporting only and no personnel will be available to answer legal questions. These seminars should be of interest to data processing and MIS personnel. Call CWF for the location and date nearest you, or see IRS Announcement 97-57 to obtain this information. PD

Prototype IRA Agreements and SIMPLEs

Most institutions that are offering the new SIMPLE-IRA retirement plan are doing so by using one of the two IRS Model SIMPLE documents, the 5305-SA custodial agreement or the 5305-S trust agreement, as the underlying IRA document. There are institutions, however, who have IRA prototype plan agreements in place who may wish to preserve most of the terms contained in these documents in any SIMPLE IRAs they offer. It is now possible to do this in a very simple and inexpensive manner.

The IRS has issued Revenue Procedure 97-16 which deals with prototype SIMPLE-IRA agreements. This Revenue Procedure relates to the underlying IRAs that each participating employee in the SIMPLE plan must have. It does not relate to the SIMPLE plan agreement the employer must sign in order to establish a SIMPLE retirement plan. Under the Revenue Procedure there are two different ways an institution could use a prototype SIMPLE-IRA. The first is probably the easiest and least expensive. The IRS has written a Model Amendment that can be added to an already existing IRA prototype document to convert this into a SIMPLE-IRA document. In order to use the Model Amendment approach, the base IRA document must have received an opinion letter from the IRS on or after January 31, 1990 or must have received an opinion letter prior to that date and has adopted the required minimum distribution language found in Revenue Procedure 92-38. Adopters of the Model Amendment will have to file for an opinion letter with the IRS. Any filing under the Model Amendment approach must be made by December 31, 1998. The filing fee for this opinion letter will be $50. The language that must be used and the filing procedures can be found in the Revenue Procedure.

The second approach that can be used is to draft a completely new SIMPLE-IRA prototype document. The document must be a SIMPLE-IRA plan agreement only and cannot be used as a regular IRA agreement. This approach will involve drafting costs and a filing with the IRS for an opinion letter. The IRS filing fee under this approach is $500. With these types of costs, it is fairly obvious that most institutions with prototypes will go with the Model Amendment approach.

One last notation that must be addressed relates to the written disclosure statement that must be given to the accountholder at the time an IRA is established. The Revenue Procedure makes it very clear that under either approach, the Model Amendment or a brand new prototype plan agreement, the written disclosure statement must also be amended or written to cover the new SIMPLE rules. Please feel free to call Collin W. Fritz and Associates, Ltd. for any help you may need in updating or drafting a SIMPLE-IRA prototype document. PD

A Caution Area for a Resigning Qualified Plan Trustee

A recent case in the Third Circuit U.S. Court of Appeals appears to impose a new, but limited duty on the trustee of a qualified plan who is resigning that position. The new duty this case imposes in some situations is that the trustee must inform the plan participants that the trustee is resigning and provide the reason for the resignation. To understand the court's ruling, it is necessary to briefly examine the factual situation that occurred in this case.

A bank was serving as the trustee of a 401(k) profit sharing plan. Over the course of the plan's existence, the employer was often late in remitting required employer matching contributions to the plan. The employer was also uncooperative with the trustee when information about the plan's administration was requested by the trustee. The pattern of the employer deposits continued to the point where the employer had failed to deposit any employer matching contributions for two years and was not providing any information to the trustee. At this point the trustee became aware that the employer was having serious financial problems. The trustee's response was to notify the employer that they intended to resign as trustee under the terms of the 401(k) plan. The bank trustee repeatedly asked the employer to appoint a successor-trustee. The employer failed to do so. After repeated attempts to get the employer to name a successor-trustee failed, the bank resigned and designated the employer as the trustee. All the plan assets were then forwarded to the employer. Upon receipt of the plan assets, the employer converted them to his own use.

A lawsuit was filed against the bank by one of the employees of this employer seeking to recover his plan benefits from the bank-trustee. The U.S. District Court held that the bank had breached the fiduciary duties it owed to the employee as a beneficiary under the plan and as such was responsible to the employee for the employee's benefits under the plan. This decision was affirmed in the Third Circuit U.S. Court of Appeals. The Third Circuit stated that the bank-trustee's "knowledge of the company's problems in conjunction with the employer's failure to respond to numerous attempts to communicate about the future administration of the plan" constituted sufficient information for a reasonably prudent trustee to realize that turning over the plan assets to the employer posed a "real threat" to the beneficiaries of the plan. The court concluded that allowing the plan fiduciary, i.e. the bank trustee, to resign without notice to the plan participants in a situation where the fiduciary had information that indicated that the plan participants and beneficiaries needed protection would undermine the goals of ERISA. The Third Circuit did stress that its ruling was limited to a fairly narrow set of circumstances where it was likely that harm would result to the plan participants and beneficiaries as a result of the trustee's resignation without notice. The court went on to say that it did not hold that the bank trustee was prevented from resigning as trustee, but rather than it could not appoint the employer as the successor-trustee, "at least not without giving the plan beneficiaries a reasonable advance notice" of the resignation and the reasons it was resigning as trustee.

What does this mean then for a financial institution that acts as trustee for a qualified plan? The ruling in this case indicates that a qualified plan trustee may not resign as trustee of a plan where the trustee is aware of facts and circumstances that could endanger the plan participants' benefits under the plan without giving notice to the plan participants of the trustee's pending resignation and the reasons for the resignation. In this case there was a combination of the trustee's knowledge of the employer's financial problems and a failure by the employer to communicate with the trustee regarding administration of the plan. These two factors should have put the "prudent person" on notice that the plan assets would be in jeopardy if turned over to the employer. A plan trustee then, who is dealing with a "problem plan," needs to exercise caution before making the decision to resign as trustee. When a trustee is dealing with a situation similar to this one, resignation without notice to the participants would appear to place liability on the trustee for any plan assets turned over to the employer. If a trustee is facing a situation like this one, the trustee should provide notice to the employer and the plan participants of its decision to resign and provide the reasons for the resignation. This notice should be provided at a reasonable time prior to the resignation becoming effective. The plan participants need this time in order to take action to protect their plan benefits. PD