The Pension Digest

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Distributions from 401(k) Plans and/or IRAs to Be Used to Pay Education Expenses

The rules and laws governing distributions from qualified plans and IRAs are not always the same. Oftentimes people don't know this fact, and obviously, it is important to know when the laws and rules are different. Otherwise, a person (or an employer who sponsors a qualified pension plan) will learn an expensive tax lesson the hard way.

The rules that apply to "education" distributions are different. Recent tax law changes have bestowed special and favorable tax treatment on certain distributions used to pay education expenses. A person must be careful, however, because there is a fair amount of incorrect information being furnished by "information providers."

The critical questions with respect to any proposed distribution situation are: (1) is the person entitled or eligible to take a withdrawal; and (2) what are the tax consequences related to the withdrawal?

A financial institution recently sent us an article which had been sent to their customer which contained the following statement, "Because you will be using the money to finance higher education, your company, like most, will let you withdraw enough money from your 401(k) plan to pay for as much as a year's worth of college expenses."

This statement is simply wrong.

Access Issue

For some time the law has authorized the rollover of almost all distributions made by a qualified plan to a participant or beneficiary to an IRA or other qualified plan. In general, all QP distributions to a participant qualify (including any partial distribution) to be rolled over except the following two types: (1) any required minimum distribution; and (2) any distribution which is part of a series of distributions and the series is either for the individual's life or for a period of more than 10 years. Distributions to a beneficiary of a deceased qualified plan participant are not eligible to be rolled over unless the beneficiary is the spouse of the deceased participant.

A precondition to being able to roll over a distribution from a qualified plan is the requirement that the qualified plan document must authorize the distribution to the participant or beneficiary. Does a participant of a 401(k) plan or any other type of qualified plan qualify to receive a distribution from a a 401(k) plan because he or she wants to use the funds to pay the education expenses of a child?

The answer is "no" for most participants.

Most qualified plans are written so that a participant is not entitled to receive a distribution until he or she has attained the normal retirement age (e.g. 59 1/2, 62, 65 , etc.) or has separated from service. However, the law creates an exception for a profit sharing plan to permit distribution to a participant at any age as long as the contribution has met a two-year holding requirement. The profit sharing plan must be written to allow this special distribution rule and most employers choose to not authorize this "liberal" distribution provision.

The law requires that a 401(k) plan have stricter distribution provisions than a standard profit sharing plan. Under a 401(k) plan, a participant cannot receive a distribution from the plan unless he or she has separated from service, has attained age 59 1/2, has incurred a financial hardship or unless some other special rule would apply. The special rules do not apply to

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Good News— Penalty Relief for TIN Errors for 1996 and 1997 Forms 1099-R

The IRS is set to release Announcement 98-73. In most cases, the IRS has decided to not impose the $50.00 per return penalty it could have assessed if a 1996 or 1997 Form 1099-R had been filed with a missing or an incorrect TIN (taxpayer identification number). A TIN is considered missing if there is no entry in the TIN block of a Form 1099 or if the number is obviously incorrect. A number is obviously incorrect if, for example, it does not have nine characters or it includes alpha characters. A TIN is incorrect if the name/TIN combination on a Form 1099 does not match the name/TIN combination found in IRS and Social Security files.

The entire Announcement is set forth here. It is important, you should read it and follow what it says.

Announcement 98-73

Penalty Relief for TIN Errors for 1996 & 1997 Forms 1099-R

In early August, the Internal Revenue Service (IRS) will send certain filers of Form 1099-R (payers of distributions from pensions, annuities, retirement or profit-sharing plans, individual retirement accounts, insur

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this situation. Note that paying for education expenses is not a reason which qualifies one for a distribution. Although many people may well believe that paying any and all education expenses is a financial hardship, the term "financial hardship" has a very specific meaning for 401(k) purposes. Hardship is defined as an immediate and heavy financial need, but the person may not have any other available resources; the following reasons qualify as immediate and heavy: deductible medical expenses (within the meaning of section 213(d) of the Code) of the employee, the employee's spouse, children, or dependents; the purchase (excluding mortgage payments) of a principal residence for the employee; payment of tuition for the next quarter or semester of post-secondary education for the employee, the employee's spouse, children or dependents; or the need to prevent the eviction of the employee from, or a foreclosure on the mortgage of, the employee's principal residence.

In summary, most 401(k) participants are not eligible to withdraw any of their 401(k) funds to pay education expenses. A few may be eligible—those over the normal retirement age or those who do have a financial hardship as defined above. However, even if eligible for the distribution because the person has a financial hardship, the 1998 tax legislation creates the new rule that any hardship distribution from a qualified plan is NOT eligible to be rolled over. This person cannot move the funds from the 401(k) to an IRA and then take withdrawal from the IRA to avoid the 10% excise tax even if he or she wanted to use the funds to pay education expenses.

In contrast, a person with an IRA has immediate access to his or her IRA funds for "educational" purposes or for any other purpose. A person should keep this in mind when deciding where to make his or her contributions.

Tax Issues

There are two basic tax issues. First, the general rule is that a distribution from a qualified plan or an IRA will be required to be included in income by the recipient at ordinary tax rates. Some distributions from qualified plans qualify for five- or ten-year averaging. Second, most distributions which are made to a recipient who is not yet age 59 1/2 will be subject to a 10% excise tax. There are, however, exceptions, and these exceptions are not the same for distributions from qualified plans and IRAs.

Code section 72(t)(2)(E) was added by The Taxpayer Relief Act of 1997. The 10% excise tax which applies to most distributions occurring before age 59 1/2 will not apply if the distribution is used to pay certain qualifying education expenses. This new rule applies to those distributions occurring after December 31, 1997, with respect to expenses paid after such date for education furnished in academic periods beginning after such date.

Code section 72(t)(2)(E) reads as follows:

(E) DISTRIBUTIONS FROM INDIVIDUAL RETIREMENT PLANS FOR HIGHER EDUCATION EXPENSES.—Distributions to an individual from an individual retirement plan to the extent such distributions do not exceed the qualified higher education expenses (as defined in paragraph (7)) of the taxpayer for the taxable year. Distributions shall not be taken into account under the preceding sentence if such distributions are described in subparagraph (A), (C), or (D) or to the extent paragraph (l) does not apply to such distributions by reason of subparagraph (B)

Note that this special rule applies to distributions from an individual retirement account (either a traditional or Roth IRA). This special rule does not apply to distributions from qualified plans. That is, a person, age 48, who has a 401(k) balance of $47,000 and who has separated from service will owe the 10% excise tax if he or she withdraws $15,000 from the 401(k) and then pays the education expenses of a child.

Also, note that the recipient cannot use this "education" exception if any of the other exceptions would apply (e.g. disability, death, substantially equal, medical, etc.)

Planning Technique. A person in a 401(k) plan who is eligible for a distribution and who wishes to use the funds to pay education expenses should first move the 401(k) money to an IRA via a rollover or direct rollover and then take the distribution from the IRA. The distribution from the IRA will not be subject to the 10% excise tax.

Be aware that The Taxpayer Relief Act of 1997 also authorized that certain distributions from an IRA (and not from a qualified plan) used for a first-time home purchase would also not be subject to the 10% excise tax. Again, a person may well wish to roll over funds from the qualified plan (assuming he or she is eligible for a distribution) to an IRA and then take the distribution from the IRA. PD

Reminder —
Required Distributions Cannot Roll Over from Qualified Plans

All IRA custodians/trustees are aware that some qualified plan administrators do not understand the rollover and direct rollover rules as well as they should. Even though the law is settled that a required distribution from a qualified plan is not eligible to be rolled over, many qualified plan administrators fail to know the rule or intentionally fail to comply.

An example. Roberta Kwan is age 74. She is a participant in her employer's 401(k) plan. She quit working on 5-30-98. Her employer has told her that she is eligible to roll over her entire account balance of $144,000 to an IRA. She had designated her daughter, Toni, as her beneficiary under the plan. The employer has told her that she did not need to worry about taking her required minimum distribution (RMD). She has told you (i.e. the IRA custodian/trustee) what the qualified plan administrator had told her.

Discussion. Required minimum distribution amounts are not eligible to be rolled over or directly rolled over. This rule is statutory. It is found in Code section 401(a)(9). There is no exception. The IRS has no authority to create any regulatory exception. A participant's required beginning date is the April 1 of the year following his or her first distribution calendar year. For those QP participants who keep working past 70 1/2 and then terminate, their first distribution calendar year is the year of separation.

Under the MDIB rules, the divisor for a person age 74 is 22.7. This means her required distribution is $6,344, which must be distributed to her by 12/31/98. The amount eligible for rollover is $137,656. The RMD amount of $6,344 is not an inconsequential amount. Anyone would prefer to not pay the 6% excise tax or the 50% excise tax on such an amount, should the RMD amount be mistakenly rolled over.

It would be best if you as the IRA custodian/trustee tried to educate the QP administrator so that this amount is not rolled over. If you have no luck convincing the QP administrator, then the excess contribution should be withdrawn as soon as possible. PD

Traditional IRA Distribution— Some May Escape Taxation

Many people are pondering into which type of IRA they should make their 1998 and future contributions. They are eligible for a deduction on the traditional IRA, but the tax-free distribution from the Roth IRA sounds very appealing. After all, when they do retire they will want as few expenses as possible, and paying taxes isn't the way they will want to be spending their income. Maybe the Roth IRA is the way to go ... or is it? Lets look at some facts and examples.

The determining factor as to whether your taxable IRA distributions are actually going to be taxed or not, depends on your adjusted gross income in the year of the withdrawal. Adjusted gross income is from line 32 of Form 1040, and includes wages, interest, dividends, and pension income. Social security benefits may or may not be taxable, but in the income levels we will be discussing, the social security benefits will be tax-free.

The current tax rules provide for a standard deduction and a deduction for exemptions. The taxpayer's adjusted gross income is first reduced by the standard deduction and then by the number of total exemptions.

The amount of each person's exemption is $2,650. If you are single, you use $2,650 as your personal exemption. If you are married, you each have a personal exemption, so you multiple $2,650 by two and use $5,300.

The amount of the standard deduction is determined by the accompanying chart. To calculate your deduction, you look at the chart and find the amount that pertains to your situation, based on your age, marital status and tax-filing status. If an individual itemizes their deductions rather than using the standard deduction, they use the amount on line 28 of Schedule A. The more deductions you can claim, the larger your IRA distribution can be, while still saving on taxes.

For many people, after these two deductions are subtracted from the adjusted gross income, the person's taxable income will be zero. This means that the IRA distribution was tax-free. Sometimes the net amount after the deductions will be less than the actual amount of the IRA distribution, so the distribution will only be partially taxed.

Example 1: Trevor is age 67, and his wife Tracy is age 61. Neither is blind and they file a joint tax return. Their house and car are paid for and they have no debts. They have a nice savings portfolio in addition to their IRA which has a balance of $150,000. They will net a taxable interest and dividend income of $8,000 from their savings, in addition to their social security benefits. They have no other taxable income. In 1998 Trevor withdraws $4,500 from his IRA.

Their adjusted gross income will be $12,500. Because this is less than $13,000 ($5,300 for their combined exemption plus the standard deduction of $7,700), they will not owe any federal income tax on their IRA distribution of $4,500, nor will they even be required to file a tax return.

Example 2: Clara is single, age 68, and not blind. She has taxable interest and dividend income of $1,000 and a pension in the amount of $6,000, in addition to her social security income. She has no other taxable income. In 1998 Clara withdraws $5,000 from her IRA which has a balance of $90,000.

Clara's adjusted gross income will be $12,000. Because this is more than $7,800 ($2,650 exemption plus the standard deduction of $5,150), she must file an income tax return and pay a tax equal to 15% of $4,200 ($12,000 - $7,800), or $630.

IRA distributions can be structured over a number of years to minimize the taxes. As you can see from these two examples, some taxpayers will not pay any income tax on all or a portion of their traditional IRA distribution. Even though a deduction was received when the funds were originally contributed, if the total taxable income for the year of withdrawal is sufficiently low, no taxes will be owed on the distribution.

Maybe the traditional IRA is still the best way to go after all, at least for individuals who won't have a large taxable income. PD

CHARTS FOR THE STANDARD DEDUCTION

Regular Chart (Filing Status) (Those Not 65 or Older or Blind)

Single	$4,150
Married Filing Jointly (or qualifying widower)	$6,900
Head of Household	$6,050
Married Filing Separately	$3,450

Special Chart for Those 65 or Older and/or Blind

Single - 65 and older	$5,150
Single - 65 and older and blind	$6,150
Married Filing Jointly - one 65 and older and neither blind	$7,700
Married Filing Jointly - one 65 and older and one blind	$8,500
Married Filing Jointly - one 65 and older and two blind	$9,300
Married Filing Jointly - two 65 and older and neither blind	$8,500
Married Filing Jointly - two 65 and older and one blind	$9,300
Married Filing Jointly - two 65 and older and two blind	$10,100

Qualifying Widower - Same Charts Apply as for Married Filing Jointly (Above)

Head of Household - 65 and older	$7,050
Head of Household - 65 and older and blind	$8,050

Married Filing Separately - use same charts that apply for Married Filing Jointly except reduce each amount by $3,450.

Penalty Relief—*Continued from page 1*

ance contracts, etc.) lists of payees whose taxpayer identification numbers (TINs) on 1996 Forms 1099-R filed with the IRS have been identified as missing or incorrect based on the IRS matching process. Most of these listings will be included with the Notice 972CG, but some will be sent separately. The law provides a penalty of $50 per return for filing an information return with a missing or incorrect TIN. For 1996 and 1997, for the Forms 1099-R only, the IRS will not assess this TIN penalty, merely because the TIN has been identified as missing or incorrect based on the IRS matching process. In certain cases this penalty may be assessed after an examination of a payer's returns. Payers should use these listings to correct their records and perform necessary solicitations to obtain correct payee information to establish reasonable cause for any TIN penalties in future years. The IRS will still send out proposed penalty notices for the 1996 Form 1099-R, as well as for other information returns, in early August to those who filed later or failed to file on magnetic media when required to do so.

Questions & Answers on the Form 1099-R TIN Listing

Q1. Why is the IRS sending this listing?

A1. The IRS is sending this listing so that the payer can compare the data on it to the information in its records and then take steps to secure correct payee information so that future information returns may be filed accurately.

Q2. What is contained in this listing?

A2. This listing consists of the Forms 1099-R filed for Tax Year 1996 that have been identified as having missing or incorrect TINs based on the records of the IRS and the Social Security Administration (SSA).

Q3. When does the IRS consider a TIN to be missing or incorrect?

A3. A TIN is identified as missing if there is no entry in the TIN block of a Form 1099 or if the number is obviously incorrect. A number is obviously incorrect if, for example, it does not have nine characters or it includes alpha characters. A TIN is identified as incorrect if the name/TIN combination on a Form 1099 does not match the name/TIN combination found in IRS and SSA files.

Q4. What should be done with the information in the listing?

A4. The payer should compare the information in the listing with its records to identify accounts or records with the same name/TIN combination and account or other number (if provided). The IRS recommends that the payer contact these payees and ask them for the correct name/TIN combination that can be used on future information returns. Although a certified TIN is not required from these payees, the payer may use Form W-9, "Request for Taxpayer Information Number and Certification," for this purpose. The payer should also check its records for errors (such as transposition of digits) so that the correct name/TIN combination can be used on any future information returns.

Q5. What should be done if the payer does not have a payee's TIN?

A5. The payer should comply with the TIN solicitation requirements in Regulations section 301.6724-1(e). In addition, Federal income taxes should be withheld from any payments made to the payee that are designated distributions under Code section 3405. In the case of nonperiodic payments, a flat rate of 10% should be withheld on non-eligible rollover distributions. On eligible rollover distributions, the withholding rate of 20% should continue to be used. In the case of periodic payments, the payer should withhold using the wage withholding rates for a single taxpayer claiming zero (0) allowances.

Q6. What should be done if a payee refuses or neglects to provide a TIN?

A6. The payer should withhold under the provisions of Code section 3405. See Q&A 5.

Q7. What should be done if a payee provides the same name and TIN that was on the listing?

A7. The payer should continue to use the name and TIN provided and keep a copy on file of the documentation received from the payee.

Q8. What should be done if a TIN was actually on file but was left off the Form 1099 or reported incorrectly?

A8. The payer should make the change to its records and use the correct information on future filings.

Q9. Will the IRS impose a penalty under Code section 6721 with respect to the information returns merely because a TIN is identified as missing or incorrect on this listing?

A9. No. In August 1998 (for Tax Year 1996), the IRS is providing this listing so that payers can obtain correct name/TIN information for use on any future Forms 1099-R filed. Incorrect name/TIN combinations and missing TINs on future Forms 1099-R may result in a penalty.

✓✓✓ Check It Out ✓✓✓

Question. Is It Permissible for a Nonspouse Beneficiary to Roll Over an Inherited IRA into His or Her Own Name?

✓ **Answer.** No. A nonspouse beneficiary of an IRA has no legal authority to treat the decedent's IRA as his or her own or to roll over funds from an inherited IRA to his or her own "regular" IRA.

Discussion. Internal Revenue Code regulation 1.408-2(b)(7)(ii) provides that any beneficiary may elect to treat a decedent's IRA as his or her own. This regulation was adopted on 8-7-80 and does not reflect later law changes.

Code section 408(d)(3)(C) denies rollover treatment for inherited accounts. By definition, an inherited account for these purposes exists only if the beneficiary is not the spouse of the decedent. Code section 408(d)(3)(C) was enacted in 1982, and first applied to individuals dying after 12-31-83. This statute changed the rule set forth in the regulation. No longer can a nonspouse beneficiary move money from an inherited IRA (i.e. Sam Smith as beneficiary of John Smith's IRA) to his or her own personal IRA (i.e the IRA of Sam Smith). The basic concept of the law is to require distributions from inherited IRAs within certain time deadlines. The IRA is not meant to be a never-ending tax shelter. It is permissible to move funds from one inherited account at one IRA custodian to another inherited account with a different IRA custodian. Inherited accounts cannot be added to regular accounts and must be kept separate from other inherited accounts.

IRS Publication 590 contains the following statement about this issue:

Inherited IRAs

If you inherit an IRA from your spouse, you generally can roll it over into an IRA established for you, or you can choose to make it your own as discussed in chapter 2 under *Inherited IRAs*. Also see *Distributions Received by a Surviving Spouse* later in this chapter.

Not inherited from spouse. If you inherited an IRA from someone other than your spouse, you cannot roll it over or allow it to receive a rollover contribution. You must withdraw the IRA assets within a certain period. For more information, see *Beneficiaries* in chapter 5.

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.