THE Pension Digest

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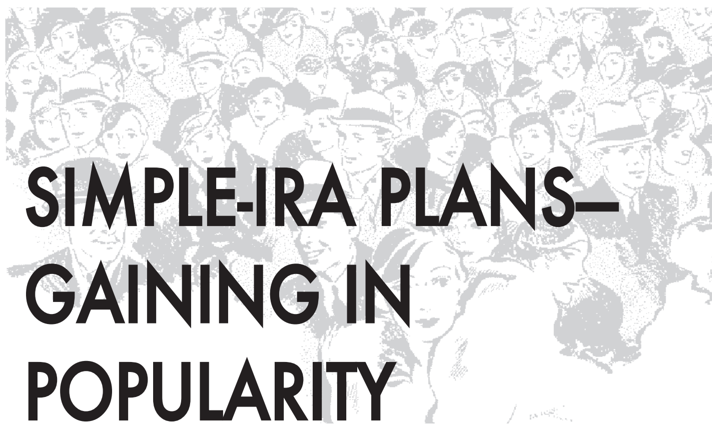

SIMPLE-IRA PLANS– GAINING IN POPULARITY

The trend may be slow, but more and more small businesses are starting to figure out that the SIMPLE-IRA plan may be the right retirement plan for them.

In the past we have forecast that the growth of SIMPLE-IRA plans should be similar to the growth of home equity loans. The various tax and banking laws in combination favor home equity loans. The same is true for SIMPLE-IRA plans. These plans have some features which will make them very attractive to many small and medium-size businesses (i.e. those with 100 or fewer employees), including one-person businesses.

Generally, it takes three to five years for new laws to be sufficiently understood so that people are willing to implement the law change. This time frame seems to be applying to SIMPLE-IRA plans which were first available as of January 1, 1997.

What makes the SIMPLE-IRA plan attractive to a small business (i.e. an employer)?

1. The employer makes only matching contributions to this plan. The employer is not required or permitted to make any other type of contribution. The employer only makes a matching contribution for an employee if he or she makes an elective deferral.

2. The employer need not make matching contributions for many part-time employees. An employer need not make contributions for an employee unless he or she has: (1) received at least $5,000 in compensation from the employer during any two preceding years, and (2) is reasonably expected to receive at least $5,000 in compensation during the year.

3. The employer is required to match the amount an employee electively defers, but only to the extent of the lesser of: 3% of his or her compensation, or $6,000. For example, an employee with compensation of $26,000 could elect to defer $4,000. The employer's matching contribution would be $780 ($26,000 x 3%). In some situations the employer may set its matching percentage at less than 3%.

The maximum elective deferral which an employee can make is $6,000.

Many owners of small businesses will discover that the amount they have to contribute for non-key employees will decrease substantially (possibly 50% or more) under a SIMPLE-IRA plan versus a profit sharing plan. This decrease in the contribution amount for the non-key employees will have to be weighed against the contribution total for the owner and key employees, which may also decrease. For example, assume there is a hypothetical business which has 28 employees. Total employee compensation is $853,450, of which $200,000 is the owner's. A contribution of 6% to a profit sharing plan would give the owner a contribution

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SIMPLE-IRA Plans, Continued from page 1

of $12,000, which is the same amount he or she receives under a SIMPLE-IRA plan ($6,000 deferral plus a $6,000 match). The cost of a 3% match under the SIMPLE-IRA would be $19,468.50 ($653,450 x 3%). However, 6% times the employees' compensation of $653,450 means the employer contributions for these employees under the profit sharing plan is $39,207. Thus, the owner can save $19,738.50 ($39,207 minus $19,468.50) by funding a SIMPLE-IRA plan rather than a profit sharing plan.

4. A self-employed person can contribute more to a SIMPLE-IRA plan than he or she could contribute to a profit sharing (Keogh) plan as long as his or her net earnings are less than $64,280.

5. A self-employed individual or an employee can contribute 100% of his or her compensation to a SIMPLE-IRA plan, whereas a 15% limit applies to a profit sharing plan.

6. The employer has less administrative hassles. The employee sets up his or her own SIMPLE-IRA, is responsible for the investments, and assumes the liability for the investments. These SIMPLE-IRAs would be set up with your institution.

7. The employer and the custodian/trustee are NOT required to prepare a Form 5500 filing report. The custodian/trustee is required to provide the employer with a summary description, and the employer is required to notify the employees they may make elective deferrals and is required to furnish them a copy of the summary description.

In summary, SIMPLE-IRAs will be the right retirement plan for many small businesses. They simply need to be furnished basic information so they and their advisors can learn about the benefits of these plans. Deposits and service fees should follow. The SIMPLE-IRA plan may also be the right plan for your bank. ◆

IMPOSING A DISTRIBUTION SCHEDULE UPON THE INHERITING BENEFICIARY

Under most IRA plan agreements, an IRA accountholder will have the authority to set the distribution schedule to be used by the IRA beneficiary after he or she dies. Presently many IRA accountholders choose to not exercise this right or they do not understand they have this right. Most IRA accountholders allow their beneficiaries to decide when it is best for them to withdraw the IRA funds. In fact, because most IRA accountholders do not impose a distribution schedule, some IRA personnel come to mistakenly believe that the IRA accountholder does not have this right. Any inheriting beneficiary must comply with the required distribution rules—certain rules if the accountholder died before his or her required beginning date and certain rules if the accountholder died on or after his or her required beginning date.

The IRS has written paragraph 4(B) of Article IV of the model Form 5305-A as follows: "If the depositor dies before distribution of his or her interest has begun, the entire remaining interest will, <u>at the election of the depositor</u> or, if the depositor has not so elected, at the election of the beneficiary or beneficiaries, either (i) be distributed by December 31 of the year containing the fifth anniversary of the depositor's death, or (ii) be distributed in equal or substantially equal payments ..." (Emphasis added.)

Why would an IRA accountholder want to place limits on when his or her beneficiary could take withdrawals? The general answer would be: the IRA accountholder does not want the beneficiary (i.e. a child or a grandchild) to have the right to take a lump-sum distribution. Rather, the accountholder may want to impose on the beneficiary the requirement to take withdrawals over his or her life expectancy. For example, an IRA accountholder age 60 may mandate that should she die, her 23-year-old beneficiary son will be required to use the life-distribution rule. She does not want him to "waste" the funds by taking a lump-sum distribution and paying off credit card debt. She wants him to continue to take advantage of the beneficial tax deferral which occurs within the IRA.

The above planning concept will certainly apply to trust IRAs more than custodial or retail IRAs, but this concept will also come to apply to retail IRAs. ◆

NO SPECIAL REPORTING CODE FOR REQUIRED DISTRIBUTIONS

From time to time an IRA accountholder or beneficiary will have the idea that he or she wants one check for the required distribution and a second check for the remaining portion of the distribution. In a possible rollover situation, it is a good idea for the IRA custodian to issue two checks because the RMD amount is clearly indicated by one of the checks, and this amount is not eligible to be rolled over.

As indicated below, in most other distribution situations, it generally serves no good purpose to issue a separate check for the required distribution amount. Here is an illustration. An IRA accountholder who was subject to the required distribution rules died in 1999. She had not yet been paid her required distribution for 1999. She had two beneficiaries—a daughter and a son. Each was to receive 50%. Each beneficiary has decided to withdraw his or her entire 50% share. Their accountant has instructed them that your financial institution as the IRA custodian MUST prepare four different checks: (1) one to the son for the required minimum amount; (2) one to the son for his remaining amount; (3) one to the daughter for her required minimum amount; and (4) one to the daughter for her remaining amount.

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No Special Reporting Code, Continued from page 2

You, as the IRA custodian, could certainly choose to prepare four checks as a customer service, but there is no legal or tax reason mandating the preparation of four checks.

There must, of course, be two checks. One for the son and one for the daughter, as each must include the amount he or she received in income for 1999.

The IRS does not require an IRA accountholder, IRA beneficiary or IRA custodian, via any IRS tax reporting forms, (e.g. Form 1099-R, 1040, etc) to inform the IRS, the accountholder or the beneficiary whether or not a required distribution has been paid. The IRS' instructions for completing the Form 1099-R do not contain a special distribution code for the payment of a required minimum distribution. Maybe there should be a special code, but there is not. The only way the IRS can determine if a taxpayer (accountholder or beneficiary) has complied with the required distribution rules is to ask for information when an audit is conducted.

Also, remember that the IRS instructions for the Form 1099-R make it very clear that even though there are multiple distributions (i.e. checks), that as along as the box 7 reason code is the same, there will be one aggregated Form 1099-R prepared.

In the current situation, the required distribution has been taken by each beneficiary because each has closed out his or her beneficiary IRA.

If the accountholder had not died and she had chosen to close out her IRA, the IRA custodian would still prepare only one Form 1099-R using a distribution code "7" to report both types of distributions—the required portion and the nonrequired portion. This would be true even if there had been two or more checks.

In summary, the IRA custodian could prepare four checks to "give the two beneficiaries what they want," but there is no legal or tax reason served by preparing four checks versus two checks. Just because an extra check is prepared, the IRS is NOT informed via any reporting forms that the one check was the required minimum portion and the other check was the nonrequired portion. ◆

RMD QUESTION

An IRA accountholder designated her spouse as her primary IRA beneficiary. He is age 65 in 1999. The accountholder dies in 1999. She would have attained age 70 1/2 in 1999. She has died before her required beginning date (i.e. the April 1 of the year following the year the accountholder attains age 70 1/2). He does not want to treat her IRA as his own. He will elect to use the life-distribution rule and not the five-year rule. *Does he have until December 31, 1999, or December 31, 2000, to take his first distribution under the life-distribution rule?*

Answer. His deadline is December 31, 2000.

Discussion—Code section 401(a)(9)(B) sets forth the statutory rules for mandated payments to a beneficiary when the accountholder dies before his or her required beginning date.

(B) Required distribution where employee dies before entire interest is distributed.—

(i) Where distributions have begun under subparagraph (A)(ii).—A trust shall not constitute a qualified trust under this section unless the plan provides that if—

(I) the distribution of the employee's interest has begun in accordance with subparagraph (A)(ii) and

(II) the employee dies before his entire interest has been distributed to him.

The remaining portion of such interest will be distributed at least as rapidly as under the method of distributions being used under subparagraph (A)(II) as of the date of his death.

(ii) Five-year rule for other cases.—A trust shall not constitute a qualified trust under this section unless the plan provides that, if an employee dies before the distribution of the employee's interest has begun in accordance with subparagraph (A)(ii), the entire interest of the employee will be distributed within five years after the death of such employee.

(iii) Exception to five-year rule for certain amounts payable over life of beneficiary.—If—

(I) any portion of the employee's interest is payable to (or for the benefit of) a designated beneficiary,

(II) such portion will be distributed (in accordance with regulations) over the life of such designated beneficiary (or over a period not extending beyond the life expectancy of such beneficiary), and

(III) such distributions begin not later than one year after the date of the employee's death or such later date as the Secretary may by regulations prescribe.

For purposes of clause (ii), the portion referred to in subclause (I) shall be treated as distributed on the date on which such distributions begin.

(iv) Special rule for surviving spouse of employee.—If the designated beneficiary referred to in clause (iii)(I) is the surviving spouse of the employee—

(I) the date on which the distributions are required to begin under clause (iii)(III) shall not be earlier than the date on which the employee would have attained age 70 1/2, and

(II) if the surviving spouse dies before the distributions to such spouse begin, this subparagraph shall be applied as if the surviving spouse were the employee.

As CWF construes the statute—the general rule is that any beneficiary must begin the life-distribution payment schedule not later than one year after the date of the employee's death or such date as prescribed by the Secretary. For simplicity purposes, the Secretary has chosen 12-31 the year after the year of death. The statute then creates two exceptions to the general rule if the beneficiary is the spouse: (1) distributions to the spouse need not commence until the date on which the accountholder would have attained age 70 1/2; and (2) if the spouse beneficiary dies before distributions commence to such spouse, then the beneficiary of the spouse will be

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able to elect between the five-year rule and the life-distribution rule.

We believe the spouse always gets the benefit of the one-year rule because that is the general rule. Thus, the surviving spouse beneficiary in this situation has until 12-31-2000 to take her first scheduled payment. The special rule states that the distributions under the general rule shall not be earlier than the date on which the accountholder dies. It does not say that such payments cannot be later than such date.

Subsection 4(b)(ii) of Article IV of the IRS model Form 5305-A reads as follows:

(b) If the depositor dies before distribution of his or her interest has begun, the entire remaining interest will, at the election of the depositor or, if the depositor has not so elected, at the election of the beneficiary or beneficiaries, either

(i) ... (five-year rule)

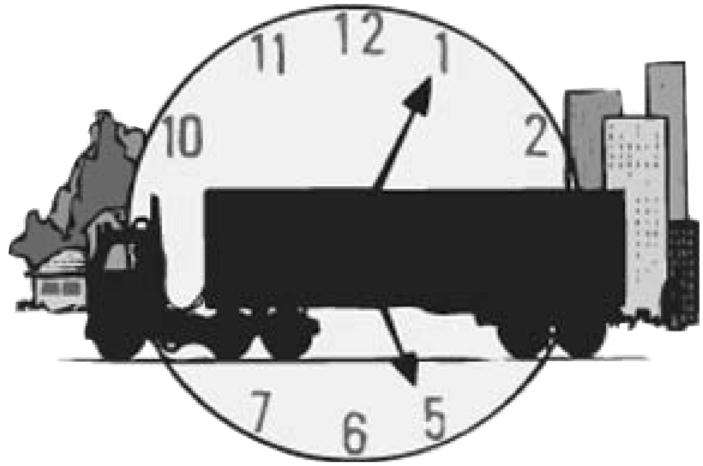
(ii) Be distributed in equal or substantially equal periodic payments over the life or the life-expectancy of the designated beneficiary or beneficiaries starting by December 31 of the year following the year of the depositor's death. If, however, the beneficiary is the depositor's surviving spouse, then this distribution is not required to begin before December 31 of the year in which the depositor would have reached age 70 1/2.

The IRS Model form gives the same answer—December 31 of the year after the accountholder dies.

As you know, in 1987, the IRS issued a proposed regulation. Q&A C-3 provides the same answer. It provides—distributions to the surviving spouse must commence on or before the LATER OF: 12-31 of the calendar year immediately following the calendar year in which the accountholder died; or (2) 12-31 of the calendar year in which the accountholder would have attained age 70 1/2. ◆

RETROACTIVE MSA CORRECTION FOR 1998

The IRS has issued Announcement 99-93 to correct an error in the 1998 instructions for Form 8853, Medical Savings Accounts and Long-Term Care Insurance Contracts and Form 5329, Additional Taxes Attributable to IRAs, Other Qualified Retirement Plans, Annuities, Modified Endowment Contracts and MSAs. The 1998 instructions were erroneous because the statement was made that the income earned on certain excess contributions from an MSA must be included in gross income for the year in which the MSA participant or the employer made the contribution. To be correct, the statement needs to be—the earnings must be included in the gross income of the participant for the year in which the earnings and the excess contributions are withdrawn. Presumably the instructions for 1999 will be correct. ◆



DESIGNATED PRIVATE DELIVERY SERVICES

The Secretary of the Treasury is required to prepare a list of private delivery services for purposes of the "timely mailing as timely filing/paying" rule of Internal Revenue Code section 7502. This rule has importance for IRA and other pension plan purposes because an IRA accountholder can mail or ship an IRA contribution on April 15 and have it be considered to be timely; an employer can mail or ship its pension contribution on its tax-filing deadline as extended by an extension, and the IRA custodian can mail or ship its Form 1099-Rs to its accountholders on January 31 and have such mailings considered to be timely.

In the past, the IRS has established the procedure of preparing this list annually. The IRS has now decided to publish a new list only if the list changes by new additions or deletions.

Effective September 1, 1999, the list of designated private delivery services ("designated PDSs") is as follows:

1. Airborne Express (Airborne): Overnight Air Express Service, Next Afternoon Service and Second Day Service;
2. DHL Worldwide Express (DHL): DHL "Same Day" Service and DHL USA Overnight;
3. Federal Express (FedEx): FedEx Priority Overnight, FedEx Standard Overnight, and FedEx 2 Day; and
4. United Parcel Service (UPS): UPS Next Day Air, UPS Next Day Air Saver, UPS 2nd Day Air, and UPS 2nd Day Air A.M.

This list has not been changed since the list published in Notice 98-47. NOTE that other delivery methods of these companies do NOT qualify. That is, three-day delivery or standard delivery do not qualify. ◆

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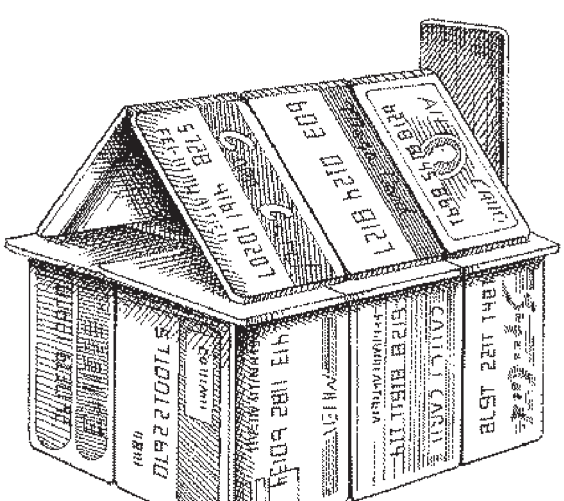
BANKRUPTCY AND IRA REPORTING

Irma Allen has $8,700 in her IRA. In July she filed for bankruptcy. She lives in Iowa, and the laws of Iowa provide the general rule that any creditor, including a bankruptcy trustee, can reach IRA assets. Irma Allen is age 33. The bankruptcy trustee, Joyce Hillman, has sent a letter to the IRA custodian/trustee saying it wants the $8,700 sent to her. She has sent the necessary supporting data to substantiate her role as the bankruptcy trustee. How should the IRA custodian/trustee bank proceed?

The IRA custodian/trustee will need to send the check to the bankruptcy trustee. Although this law is not very clear, it appears the bankruptcy trustee has the authority to instruct that it does not want withholding.

The legal effect of the attachment of the IRA by the bankruptcy trustee means a deemed distribution has occurred to Irma Allen. An IRA no longer exists. Most likely, Irma is not going to be real happy that she must include this distribution in her gross income. But she must. The IRA custodian/trustee will have to issue a 1999 Form 1099-R to her and not to the bankruptcy trustee. The IRS instructions for Form 1099-R do not expressly discuss how an IRA custodian/trustee is to handle IRS tax levies.

The general rule is that Code "1" is to be used only if the accountholder has not reached age 59 1/2 and only if none of the exceptions of Code 72(t) are known to a certainty to apply. Normally you do not know to a certainty if the medical or higher education expense exception applies because you do not know if all of the qualifying rules have been met. That is why code "1" is to be used for medical and higher education situations. That is not the case with an IRS levy. The distribution code which should be used is Code "2" since you know that a levy is a known exception under code section 72(t) to the assessment of the additional 10% tax. In 1998, the law was changed so that the 10% additional tax does not apply when the IRS places a levy upon an IRA or pension account. This change applied to levies made after July 22, 1998. ◆



✓ CHECK IT OUT

<u>Situation/Question #1</u>. An IRA accountholder had designated his trust as the beneficiary of his IRA. His three children and his former spouse were the beneficiaries of this trust. The IRA accountholder died in 1998. Approximately eight to nine months later, in 1999, one of the children died. The child's estate is to receive the child's interest from the trust. With respect to the required distributions to be made from the decedent's IRA, the trust had not yet elected between the five-year rule and the life-distribution rule at the time of the child's death. How, if at all, does the child's death affect the trust's options?

✓ Answer. We believe the trust is eligible to use the life-distribution rule for purposes of determining the required distribution to be made from the deceased accountholder's IRA to the trust. The oldest beneficiary must be used to determine the single life-expectancy factor. Presumably, this would be the former spouse. The trust would then apply its terms to determine when and how distribution would be made to the deceased child's estate.

The IRS revised the rules for trusts as IRA beneficiaries in December of 1997. These rules are summarized below.

D-5 of propose regulation 1.401(a)(9)-1 provides—while the accountholder is alive, the calculation of his or her required distribution may be based on a joint life expectancy as based on the beneficiaries of a trust if certain rules are met. The deadline for meeting the rules is—the later of the date on which the trust is named as a beneficiary or the accountholder's required beginning date.

D-6 of the proposed regulation provides the general rule that after the accountholder has died, the trust may elect to use the life-distribution rule and base the calculation of the required distribution on the life expectancy of the oldest beneficiary of the trust if certain rules are met.

D-7 of the proposed regulation sets forth certain documentation requirements and deadlines for furnishing the documentation. D-7(b) provides that the trustee must furnish the IRA custodian/trustee with certain documentation requirements (final list of who are the beneficiaries and a certification that the requirements of D-5 have been met) must be met by the end of the ninth month after the accountholder' death. However, the trustee must certify this information as of the accountholder's death and not as of nine months after the accountholder's death.

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✓ Check It Out,
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Situation/Question #2. Business #1 currently sponsors a SIMPLE-IRA plan. Business #1, or the owners of Business #1, have now purchased Business #2. For purposes of this question, it is assumed that Business #2 does not sponsor any retirement plan. Your question is, "What effect, if any, does this purchase have on the administration of the SIMPLE-IRA plan of Business #1?"

✓ Discussion and Answer.

1. Code section 408(p)(10) contains "Special Rules for Acquisitions, Dispositions and Similar Transactions." It reads as follows:

> (1) SPECIAL RULES FOR ACQUISITIONS, DISPOSITIONS, AND SIMILAR TRANSACTIONS.—
>
> (A) IN GENERAL.—An employer which fails to meet any applicable requirement by reason of an acquisition, disposition, or similar transaction shall not be treated as failing to meet such requirement during the transition period if—
>
> (i) the employer satisfies requirements similar to the requirements of section 410(b)(6)(C)(i)(II); and
>
> (ii) the qualified salary reduction arrangement maintained by the employer would satisfy the requirements of this subsection after the transaction if the employer which maintained the arrangement before the transaction had remained a separate employer.
>
> (B) APPLICABLE REQUIREMENT.—For purposes of this paragraph, the term "applicable requirement" means—
>
> (i) the requirement under paragraph (2)(A)(i) that an employer be an eligible employer;
>
> (ii) the requirement under paragraph (2)(3) that an arrangement be the only plan of an employer; and
>
> (C) TRANSITION PERIOD.—For purposes of this paragraph, the term "transition period" means the period beginning on the date of any transaction described in subparagraph (A) and ending on the last day of the second calendar year following the calendar year in which such transaction occurs.

Code section 408(p)(10) applies only if one of the qualification requirements is not met because of the purchase. There are three such requirements: (1) being an eligible employer; (2) not having any other plans; and (3) the employee participation requirements.

2. The purchase of Business #2 by Business #1 may either have been a stock purchase or an asset purchase.

A Stock Purchase

If the purchase was a stock purchase, either by Business #1 or the same owners of Business #1, then the controlled group rules of Code section 414 apply or could apply. The most conservative approach for Business #1 would be—the employees of Business #2 would be covered by the SIMPLE-IRA if they met the participation requirement using their compensation with Business #2 for the prior year's compensation requirement, and using their compensation with both employers for the current-year compensation test. The law, however, does not require an employer to immediately cover the employees of Business #2.

We read Code sections 410(b)(6)(C) and section n408(p)(10) as providing a transition period during which the employees of Business #2 do NOT need to be covered by the SIMPLE-IRA plan of Business #1. The transition period under section 408(p)(10) is two years. Thus, the employees of Business #2 would not been to be covered until the 2002 year.

Caveat and Observation—We are not sure the IRS model SIMPLE-IRA form expressly handles the inclusion or exclusion of the employees of Business #2 as well as is desired if Business #1 would make the decision to NOT cover the employees of Business #2. We would recommend an individually drafted plan document to expressly state the intent to include or exclude this acquisition (and future acquisitions) from coverage under the SIMPLE-IRA plan until the time mandated by the law for coverage.

An Asset Purchase

If the purchase of Business #2 by Business #1 was an asset purchase, then the employees of Business #2 became new employees of Business #1 and are treated as any other new hire (at least $5,000 of compensation in the prior two years and the expected $5,000 of compensation for the current year). They would have to meet the compensation requirement using their compensation with Business #1. Their compensation with Business #2 is not considered.

As with any complicated situation, your business customers with this type of situation need to be acting on the advice of their own advisors.

Situation/Question 3. An IRA accountholder has died after his required beginning date. He had designated a revocable trust as the beneficiary of his IRA. Actually, the revocable trust is really a joint revocable trust. Because only one of the settlors has died, the trust does not become irrevocable until the second spouse dies. Consequently, for tax reporting purposes the social security number of the surviving spouse is to be used.

We believe you said his surviving spouse is now the sole trustee and the sole beneficiary of this trust.

His RMD calculations had been made using a single life-expectancy factor because the trust was not irrevocable upon his death.

What distribution options exist for the trust and for his wife, if any?

✓ Answer.

1. The trust can continue his RMD distribution schedule. The trust is the beneficiary. There are two reporting options in this situation.

The first option is for the IRA custodian to set up on its data processing system the inherited/beneficiary IRA as follows. The account should be titled, "Mary Smith as trustee of the revocable trust of John and Mary Smith as the beneficiary of John Smith's IRA." The IRA custodian would generate the Form 1099-R to this trust (but use Mary's social security number) since the trust is still a revocable trust.

The second option is for the IRA custodian to set up on its data processing system the inherited/beneficiary IRA as follows. The account should be titled, "Mary Smith as the beneficiary of John and Mary Smith's revocable trust as the beneficiary of John Smith's IRA." The IRA custodian would generate the Form 1099-R to her using her social security.

The reason the second

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option is available is because of Q&A D-5 of proposed regulation 1.401(a)(9) which provides—if certain requirements are met, then distributions made to a trust will be treated as paid to the beneficiaries of the trust with respect to the trust's interest as beneficiary in the IRA.

2. She can elect to treat his IRA as her own. The IRS, in a number of private letter rulings, has allowed a surviving spouse to treat a deceased spouse's IRA as her own IRA even though a trust was the designated beneficiary as long as the surviving spouse is the sole trustee and the sole beneficiary. We understand that she is the sole trustee and sole beneficiary.

Note the fact that the trust is still a revocable trust does not prevent her from treating the IRA portion of this trust as her own IRA. If the IRA accountholder had died before his required beginning date, then the fact the trust is a revocable trust would have meant that the life distribution option would not have been available to the trust. But in this case he died after his required beginning date.

We believe it would be much easier for everyone (the bank, surviving spouse and the children) to understand the distribution options if she would elect to treat his IRA as her own. If her IRA was a new one, she then could set up her own RMD distribution schedule, if applicable, and designate new beneficiaries.

Even if she elects to treat this IRA as her own IRA, she can continue a distribution schedule similar to what he had if that is what she wants to do. There will be a longer distribution schedule if the surviving spouse would set up a new schedule with the children being the beneficiaries of the trust.

Situation/Question #4. You have an MSA accountholder/customer who has adopted the procedure of paying the medical bill of various providers from her MSA almost immediately and then redepositing the insurance reimbursement check once she receives it. You have asked if this procedure is one which should be used.

✓ Our answer is "no." We strongly recommend that this procedure not be continued and corrections will need to be made.

Her procedure is very logical and practical, but the problem is—the law as written does not expressly authorize this procedure. The law does not provide for or authorize the depositing of the insurance company reimbursement checks into an MSA account.

The MSA rules as written in Internal Revenue Code section 220 provide for the following types of contributions—

(1) annual contributions for the year which count against a limit;

(2) rollovers; and

(3) presumably transfers from one MSA or another MSA.

There is no statutory authority which authorizes the contribution of a reimbursement check. Maybe there should be, but there is not.

What tax consequences have resulted from the depositing of these reimbursement checks?

First, we believe she must count the amounts she has added into her MSA arising from the insurance reimbursements against her annual contribution limit. Consequently, she may well have excess contributions, and they would need to be corrected just like an IRA excess contribution would need to be, or the 6% excise tax will be owed. She could use the rollover rules to redeposit one of the distributions as long as the 60-day requirement is met.

Second, we believe she must include in income her withdrawals from the MSA to the extent she is reimbursed since these amounts were not used exclusively for qualified medical expenses and all but one are not eligible to be rolled over.

As mentioned above, she must consult with her own tax advisor. She should end this procedure immediately.

We suggest she (or her tax advisor) write the IRS either before or when she files her tax return. She would explain the situation and ask them if it is permissible to leave the insurance payments in her MSA. The IRS might decide to be nice to her even though under the law we don't think they would have to be.

Situation/Question #5. An IRA accountholder died in June of 1999, at the age of 62. He died before his required beginning date. His spouse is his beneficiary. She had her 53rd birthday on 9-5-99. The IRA had a balance of $124,000 on 12-31-98. She believes she will need to withdraw $12,000 per year until she reaches age 59 1/2. What option should she select to comply with the required distribution rules which apply to beneficiary accounts, and what options appears to be best for her?

✓ Answer. When the IRA accountholder has died before his required beginning date, a surviving spouse beneficiary has three options: (1) elect as her own; (2) the life-distribution rule; or (3) the five-year rule.

We believe her interests would be best served by electing the five-year rule. The deadline for the five-year rule is 12-31-2004. Thus, most likely she will wish to treat this IRA as her own on or before 12-31-2004. She will attain age 59 1/2 on May 5, 2005. Under the five-year rule she is permitted to withdraw any amount she wishes. Withdrawing at least $12,000 per year is not a problem. The only potential problem is the fact that for a little over four months, any distribution she would take would be subject to the 10% additional tax because she would not yet be age 59 1/2. This is not a major problem—she should simply take out a sufficient distribution at the end of December 2004 before she elects to treat the IRA as her own, and this amount will carry her until 5-5-2005 when she will be 59 1/2.

The initial election of the five-year rule is better than the other two options for the following reasons.

If she elected to treat as her own, she would not be able to set up a substantially equal periodic payment schedule

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✓ Check It Out,
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which would give her $12,000 per year. The amortization method with a 6% earnings rate authorizes a distribution of $8,968. The annuity factor method with a 6% earning record authorizes a distribution of $10,360.

If she elected the life-distribution rule, she would not be able to receive $12,000 per year. The calculation for the life-distribution rule would be $124,000/30.4 (factor for a person age 53), or $4,079. Although a beneficiary may withdraw more funds than the schedule which the accountholder had established when the accountholder dies after his or her required beginning date, it does not appear that a beneficiary cannot elect to receive a larger distribution than the amount which results when the life-distribution method is selected. That method is: preceding year's 12-31 balance divided by the life-expectancy factor.

Situation/Question #6. An individual deposited funds with us which were titled as profit sharing funds. This individual would like us to change the ownership of these funds from being pursuant to a profit sharing plan to being pursuant to a SEP plan. We informed the individual and his advisor that we are willing to do so, but there will need to be certain tax reporting by both the profit sharing plan and the bank as the IRA custodian. The individual and his advisor have asked for a citation of the authority that such reporting is required. What is that citation?

✓ Answer: Under current tax law there are three ways money or assets can move from one type of plan to another plan. These are rollover, direct rollover and transfer. Admittedly, the rules are complex.

The approach of the law for rollovers and direct rollovers is as follows: a rollover or direct rollover can take place only if there is statutory authority for such a rollover or direct rollover. That is, the proper approach is not—well, I can't find anything in the law which says I cannot do it, so I must be able to do it. The law is not written to support that approach. The general tax law rule is—a distribution paid from a pension plan or an IRA must be included in the recipient s income unless he or she can show why it is not taxable. Rollovers and direct rollovers are an exception to this rule, but the individual must demonstrate that a rollover or a direct rollover has occurred. That is, no taxation results as long as the rollover and direct rollover rules are met.

The approach of the law for transfers is different. There is no statutory authority for a transfer. The IRS created this concept administratively. The IRS concluded that as long as funds moved at the plan level (not at the employee level), that a reportable event (i.e. a distribution) had not taken place. The IRS has defined a transfer to be a movement of funds from one plan type to the SAME plan type.

A movement of funds from a profit sharing plan to an IRA is a rollover or direct rollover; it is not a transfer because the plan types are different. As such, the distribution is reportable by the profit sharing plan on the Form 1099-R and the contribution is reportable as a rollover on the Form 5498.

The rules authorizing the rolling over of a distribution from a qualified plan to limited other plans are found in Code section 402(c).

Note that 402(c)(8)(B) defines a plan which is eligible to accept the rollover contribution as an eligible retirement plan and that a SEP plan (Code section 408(k)) is <u>not</u> listed.

This is why we recommend that the following take place:

a. Roll over or directly roll over the funds from the profit sharing plan to a section 408(a) IRA; and

b. Then add a SEP contribution to this IRA to make the IRA become a SEP-IRA.

Conclusion. The movement of funds from a profit sharing plan to a SEP-IRA is reportable. The profit sharing plan must prepare a Form 1099-R to report the distribution and the IRA custodian will need to report, for IRA purposes, the rollover or direct rollover on the Form 5498.

We understand that this individual may have other qualified plan deposits with various brokerage firms, and these firms may have told him that they can move the money and not be required to report it. We think this is unlikely unless the brokerage firm's personnel does not understand the factual situation or they do not understand the pertinent tax rules. We would be glad to review their written authority claiming that no reporting is required. ◆