THE Pension Digest

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ELECTRONIC SIGNATURES IN GLOBAL AND NATIONAL COMMERCE ACT

The U.S. House of Representatives (426-4) and the U.S. Senate (87-0) have passed an e-commerce bill, and President Clinton has signed it. This new law will have major ramifications. As with any new law, certain ramifications may be foreseen. For example, it will now be possible to establish an IRA or any other contract entirely via the internet. There will be no requirement that the IRA custodian and the accountholder sign a paper form. The law, however, deals with much more than just electronic signatures.

The effective date for most of the law's provisions is October 1, 2000. That day is less than 100 days away.

The first purpose of this law is to have the federal law preempt most state laws (and other federal laws) which would attempt to deny the legal effect, validity, or enforcement of a signature, contract, or other record solely because it is in electronic form.

The second purpose or goal is very broad—to give an electronic form or record the same status as a written record. It will be possible to convert all existing written contracts and records to electronic format and still be able to enforce the electronic copy, as if it was an original contract or document. That is, if the law requires that a contract or record be retained for a certain period of time, then that law or regulatory requirement will be met by retaining an electronic record of the information in the contract or record. There are limits. Many times in the law, a notice must be posted, displayed or publicly affixed, and nothing in this law changes such laws.

The third purpose is what the press has primarily covered. A contract relating to such a transaction may not be denied legal effect, validity, or enforceability solely because an electronic signature or electronic record was used in its formation. The term "electronic signature" means an electronic sound, symbol, or process, attached to or logically associated with a contract or other record, and executed or adopted by a person with the intent to sign the record. The term "electronic" means relating to technology having electrical, digital, magnetic, wireless, optical, electromagnetic or similar capabilities.

The law has been written so that a person is not required to agree to use or accept electronic records or electronic signatures. That is, a person is free to demand to have a written agreement just as someone else is free to demand to have an electronic agreement.

The fourth purpose is to mandate that electronic records may be used by a business to comply with legal disclosure requirements. Four rules must be met. First, the consumer has affirmatively consented to such use and has not withdrawn such consent. Second, the consumer,

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AUTOMATIC FILING EXTENSION FOR FILERS OF THE 1999 FORM 5500-EZ

Filers of all Form 5500 Series forms whose normal returns are due by July 31, 2000, have been given an extension until October 16, 2000. It is not required that you request the extension. In PWBA News Release No. USDL:00-16 it is made clear this applies to filers of Form 5500-EZ also. The IRS, PWBA and PBGC jointly issued this extension. ◆

For more information on the 1999 Form 5500-EZ, read the article on page 3.

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prior to consenting, is provided with a clear and conspicuous statement as discussed below. Third, the consumer, prior to consenting, is provided with a statement of the hardware and software requirements for access to and retention of the electronic records and consents electronically or confirms his or her consent electronically in a manner that reasonably demonstrates that the consumer can access the information in the electronic form that will be used to provide the information which is the subject of the consent. Fourth, if a change in the hardware or software needed to access or retain electronic records creates a material risk that the consumer will not be able to access or retain a subsequent record, the person providing the electronic record must provide the consumer with a statement of the revised requirements and of his or her right to withdraw consent without the imposition of any fees for such withdrawal. This law does not affect the content or timing of any required disclosure. If the record required to be disclosed must also be verified or acknowledged, then an electronic record may suffice only if it, too, is verified or acknowledged, whichever is required. This requirement is satisfied if the electronic signature of the person authorized to perform those acts is attached to or logically associated with the signature or record.

The clear and conspicuous statement must meet the following requirements. First, the consumer must be informed of his or her right or option to have the record provided or made available on paper or in nonelectronic form. Second, the consumer must be informed of his or her right to withdraw his or her consent to have the record provided or made available in an electronic form and of any conditions or consequences such as the termination of the relationship, or fees associated with the withdrawal. Third, the consumer must be informed whether or not his or her consent applies to a particular transaction or be informed of those categories of records to which his or her consent applies. Fourth, the consumer must be informed of the procedures which must be used if he or she wishes to withdraw his or her consent and the procedures to update information which is needed to contact the consumer. Fifth, the consumer must be informed how he or she may after giving the consent, upon request, obtain a paper copy of an electronic record and whether any fee will be charged for such copy.

The effect of the consumer's withdrawal of his or her consent is to be prospective only. The law does not provide that the consumer's withdrawal of his or her consent is effective immediately as one might expect with an e-commerce transaction. A consumer's withdrawal of consent is effective within a reasonable period of time after the receipt of the withdrawal by the provider of the record. The law does not define the term "reasonable time."

There is a special grandfather provision. The above consumer rules will not apply to any records that are provided or made available to a consumer who granted his or her consent to receive such records in electronic forms as permitted by any statute, regulation, or other rule of law prior to the effective date of this law.

There is also a special provision which tries to limit the effect of a provider's failure to obtain the consumer's consent or confirmation of consent. The legal effectiveness, validity, or enforceability of any contract executed by a consumer shall not be denied solely because of the failure.

There are some laws (and topics of laws), though, which are not subject to this new electronic record law.

1. creation and execution of "Wills, codicils and testamentary trusts;
2. laws governing adoption, divorce, or other matters of family law;
3. the Uniform Commercial Code, as in effect in any State, other than sections 1-107 and 1-206 and Articles 2 and 2A;
4. court orders;
5. cancellation or termination of utility services;
6. legal actions involving a person's primary residence;
7. the cancellation or termination of health insurance or life insurance, but not annuities; and
8. the recall of any product.

If certain rules are met, this law also provides that state laws and regulations will be able to modify, limit or supersede the above requirements. These rules will be set forth in a subsequent newsletter. ◆

MAGNETIC MEDIA ELECTRONIC FILING; 2000 FORMS SPECIFICATIONS

The IRS has recently (May 22, 2000) issued Rev. Proc. 2000-25 which sets forth the specifications for the magnetic or electronic filing of 2000 Forms 1098, 1099, 5498, and W-2G. Rev. proc. 99-29 is superseded. This Rev. Proc. is comprised of 82 pages. You may order a copy from CWF by calling 800-346-3961 and requesting one. The cost is $9.00. ◆

401(k) PLANS—PARTIAL REPEAL OF THE "SAME-DESK" RULE

The IRS has recently issued Rev. Rul. 2000-27 which adopts a new definition of "separation from service" in a specific situation. The consequences of the new definition is that the sale of less than substantially all of the assets of a trade or business to an unrelated third party does not automatically preclude a distribution to the affected 401(k) participants. They may still be eligible for a distribution of

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401(k) Plans Partial Repeal, Continued from page 2

their account balance under the 401(k)(2)(B)(i)(I) definition of separation from service.

The specific situation: Employer X maintains a 401(k) plan (i.e. Plan A). Employer X sells certain assets to Employer Y, but less than 85% of the assets used by Employer X in a trade or business of Employer X. The aggregations provisions of Code section 414(b), (c), (m) or (o) do not apply to Employer X and Employer M after the sale of assets. Most of the employees of Employer X who were associated with the transferred assets terminate their employment with Employer X and are hired by Employer Y (the Transferred Employees) as of the date of the sale of assets. Such employees continue to perform, without interruption and in the same capacity, the same functions for Employer Y that they performed for Employer X before the sale. Such employees no longer perform any services for Employer X.

Issue: May the account balances of such employees be distributed to them or directly rolled over to an eligible plan?

The IRS concludes, for the following reasons, that the funds may be distributed.

Discussion of Law and Analysis

In order to qualify as a 401(k) plan, an employee's elective deferrals may only be distributed if one of the following four conditions set forth in section 401(k)(2)(B)(i) is satisfied:

1. The employee's attainment of age 59 1/2;
2. The employee's separation from service, death, or disability;
3. The employee's financial hardship; or
4. An event described in section 401(k)(10) such as:

    (i) The termination of the plan;

    (ii) The disposition of a corporation's interest in a subsidiary; or

    (iii) the disposition by a corporation to another corporation of substantially all the assets used by the selling corporation in a trade or business. By regulation, the IRS added these requirements:

A. In order to be a sale of substantially all the assets used in a trade or business, at least 85% of the assets used by the seller must be sold;

B. After the sale, the purchaser must not maintain the plan;

C. The employee receiving the distributions must continue employment with the purchaser of the assets;

D. The distribution must be made in connection with the disposition of assets; and

E. The distribution must qualify as a lump-sum distribution within the meaning of section 402(d)(4). In Rev. Rule 79-336, the IRS defined that a separation from service for purposes of qualifying to use the special forward averaging for lump-sum distributions occurs upon an employee's death, retirement, resignation, or discharge, but not when the employee continues on the same job for a different employer as a result of the liquidation, merger or consolidation of the former employer.

The sale of Employer X's assets do not satisfy the requirements of Code section 401(k)(10) and related regulations because there was a sale of less than 85% of its assets.

The IRS found in this situation, however, a separation from service within the meaning of Code section 401(k)(2)(B)(i). The Transferred Employees are not employed in a continuation of the "same" trade or business and that there has been a sufficient change in their employment status to constitute a "separation from service" within the meaning of 401(k)(2)(B)(i). Consequently, distributions may be made to the Transferred Employees of their account balances, including their elective deferrals.

The IRS stated that its finding would be the same regardless of (i) whether Employer X or Employer Y is a corporation, or (ii) whether Employer Y hires Transferred Employees pursuant to a contractual obligation.

Grace Period for Employers to Comply With New Definitions of Separation from Service

The rule is that a plan is subject to disqualification if it does not follow its provisions. All plans contain a provision that allows for distributions on account of separation from service. However, there is now a new definition of this term. As long as such sale (i.e. sale of less than substantially all the assets) occurs prior to September 1, 2000, the IRS has adopted a grace period approach: an employer will not be required to comply with this definition and therefore will not need to permit such distributions to the terminated employees hired by the buyer. ◆

DISCUSSION OF 1999 FORM 5500-EZ AND SCHEDULE P

The IRS has developed a new computerized filing system to process Form 5500 returns/reports called the ERISA Filing Acceptance System or "EFAST." To a large degree, the questions which need to be answered are the same, but the format of the forms have been changed so that they may be "read" by a computer system. The DOL and IRS adopted the tax form concept which generally applies to individuals and corporations for income tax purposes—a main form used in conjunction with many subforms (i.e. supporting schedules containing the detail information). There were many major changes for all required filers other than those who are eligible to file the Form 5500-EZ. For example, the Form 5500C/R was discontinued. The changes to the Form 5500-EZ were not that major. One must remember that the DOL/IRS' system is primarily designed so that they can administer the multiple-person plans and not the one-person plans. What may be simpler for the IRS with respect to a multiple-participant plan is not simpler for the employer who sponsors a one-person plan. Set forth below is a summary of the changes for the 1999 Form and then a general discussion. Page one of the 1999 Form 5500-EZ and the 1999 Schedule P are included as in

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1999 Form 5500-EZ,
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insert with this newsletter. Schedule P (Form 5500), Annual Return of Fiduciary of Employee Benefit Trust can be filed as an attachment to Form 5500-EZ for a one-participant plan that is funded by a trust, by any trustee or custodian to start the running of the statute of limitations for the trust.

Changes to Note for 1999.

1. The Form 5500-EZ has gone from one page to being five pages.

2. Only original copies of the form may be used. Copies will not work. Thus, you cannot use the copy herewith enclosed. The new form is printed on special paper with special green drop out ink and is printed with precise specifications. Filers should not substitute a reproduction of these machine-readable pages.

3. The 5500-EZ and the other 5500 forms are now filed with the Department of Labor's (DOL) Pension Welfare Benefit Administration (PWBA) rather than the IRS. The DOL and IRS continue to share administrative duties for ERISA plans. Where To File if by mail: PWBA, P.O. Box 7042, Lawrence, KS 66044-7042. Where to file if by private delivery service: PWBA/NCS, Attn: EFAST, 3833 Greenway Drive, Lawrence, KS 66046-1290.

4. There are now more stringent instructions on how to complete the forms so that they are "readable." See "Paper Filing" below.

5. There are three new questions added to the form. Question 4 is to be completed if the name and/or EIN of the employer has changed. Question 5 asks for preparer information such as name, address, EIN, telephone number, etc. Completing this question is optional. Question 12 is new. See below. The purpose of the question is: these listed types of investments many times involve situations which are conducive to prohibited transactions. The IRS/DOL may decide to investigate further at a later time.

General Discussion and Purpose of Form 5500-EZ

Qualified Retirement Plans, either defined contribution or defined benefit pension plans,

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6. Set forth below is our chart comparing the 1999 Form 5500-EZ to the 1998 Form 5500-EZ. As mentioned, most of the questions on the 1999 form were on the 1998, but have just been renumbered.

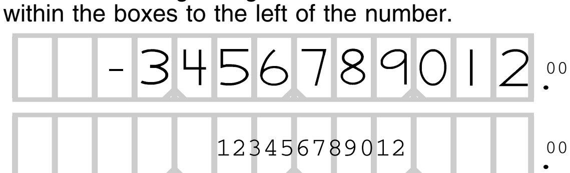
Topic of Question	Location on 1999 Form	Location on 1998 Form
Annual Report Identification Information	Top of Form	Top of Form
Plan Information	1(a)-(c)	2(b)-(d)
Signature of Employer	Bottom of Pg 1	Bottom of Pg 1
Employer Information	2(a)-(d)	1(a)-(c)
Plan Administrator Info.	3(a)-(c)	2(a)
Change in Emp. Name/EIN	4	Not Covered
Preparer Information	5	Not Covered
Type of Plan	6	3
Master/Prototype Plan	7(a)	4(a)
Plan Covers	7(b)	4(b)
Number of Plans	8(a) and (b)	5(a) and (b)
Age Categories	9	6
8 Questions Dealing With Fully Insured Plans, Contributions, Distributions, Transfers, and Expenses	10(a)-(h)	7(a)-(h)
Total Plan Assets & Liabilities	11(a)-(b)	8(a)-(b)
Specific Asset Questions	12(a)-(g)	Not Covered
Transactions Between Plan and Disqualified Persons	12(a)-(d)	9(a)-(d)
Coverage	14(a)-(c)	10(a)-(c)
Distribution Questions	15(a)-(c)	11(a)-(c)

Paper Filing

Completion by Computer. If Electronic Filing is not used, print out the Form 5500-EZ on standard 8½ by 11 inch paper using EFAST approved computer software.

Completion by Hand. Enter one letter or number within each green box without any overlapping of characters. If entering a negative number, enter a minus sign "–" in a box to the left of the number.

Completion by Typewriter. Ignore the vertical lines and type directly through the boxes. Do NOT type more characters than the number of boxes. Do NOT use commas. See example below. If entering a negative number, enter a minus sign "–" within the boxes to the left of the number.



12. Specific Assets: If the plan held any assets in one or more of the following specific categories, check "Yes," and enter the current value as of the end of the plan year. Otherwise, check "No."

	Yes	No	Amount
a. Partnership/joint venture interests	☐	☐	____________
b. Employer property	☐	☐	____________
c. Real estate (other than employer real property)	☐	☐	____________
d. Employer securities	☐	☐	____________
e. Participant loans	☐	☐	____________
f. Loans (other than to participants)	☐	☐	____________
g. Tangible personal property	☐	☐	____________

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have annual filing requirements. Employers with more than one participant are required to file either the Form 5500-C/R or Form 5500. A one-participant retirement plan may file Form 5500-EZ. A one-participant plan covers only the owner and his or her spouse, or one or more partners and their spouses.

Form 5500-EZ is required for a one-participant plan that held more than $100,000 at the end of any plan year, beginning on or after January 1, 1994. Form 5500-EZ must be filed 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.

Who May File Form 5500-EZ?

Form 5500-EZ is a simpler form than Form 5500 or Form 5500 C/R and can be used if all of the following five conditions are met.

1. The plan is a one-participant plan.

2. The plan meets the minimum coverage requirements of section 410(b) without being combined with any other plan you may have that covers other employees of your business.

3. The plan provides no benefits for anyone other than the owners and their spouses.

4. The plan does not cover a business that is a member of:

- An affiliated service group,
- A controlled group of corporations, or
- A group of businesses under common control.

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

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

There are no 5500 reporting requirements if you:

- Meet the five conditions above, and
- You have a one-participant plan that had total plan assets of $100,000 or less at the end of every plan year beginning on or after January 1, 1994; or you have two or more one-participant plans that together had total plan assets of $100,000 or less at the end of every plan year beginning on or after January 1, 1994. Note: All one-participant plans must file a Form 5500-EZ for their final plan year even if the total plan assets have always been less then $100,000. The final plan year is the year in which distribution of all plan assets is completed. If this is the final year, check the "final return" box at the top of Form 5500-EZ.

When to File

File Form 5500-EZ by the last day of the seventh month following the end of the plan year, unless you were granted an extension of time to file.

For a short plan year, file a return by the last day of the seventh month following the end of the short plan year. Modify the heading of the form to show the beginning and ending dates of your short plan year, and check the box for a short plan year. If this is also the first or final return, check the appropriate box.

Extension of Time to File

A one-time extension of up to 2 1/2 months will be automatically granted if Form 5558, Application for Extension of Time To File Certain Employee Plan Returns, is filed before the return/report's normal due date. A photocopy of the Form 5558 must be attached to the Form 5500-EZ, and the box above line 1b must be checked. Exception: One-participant plans are not required to file Form 5558 and are automatically granted an extension of time to file Form 5500-EZ until the extended due date of the Federal income tax return of the employer, if all of the following conditions are met:

- The plan year and the employer's tax year are the same,
- The employer has been granted an extension of time to file its income tax return at a date later than the normal due date for filing the Form 5500-EZ, and
- A copy of the IRS extension of time to file the Federal income tax return is attached. The box above line 1b must also be checked.

An extension granted by using this exception CANNOT be extended further by filing a Form 5558 after the normal due date (without extension) of Form 5500-EZ.

Penalties

The penalty for not filing the correct Form 5500 by the required due date is $25 a day, up to $15,000.

Form Completion

Most of the items are self explanatory, but here are a few comments on some of the lines.

- Line 2d: Choose the appropriate code from page six of the instructions.
- Line 7(a): The person must furnish the opinion letter number that the IRS 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.
- Line 10(a): This line about fully insured plans will not apply to most plan sponsors unless they have established the plan with an insurance company.
- Line 10(b) & 10(c): Plan contributions should be in cash. Question 7(c) is asking if there were any non-cash contributions (an audit question).
- Line 10(e): Asks for the amount of distributions that are nontaxable. Examples would be the return of nondeductible employee contributions or payments that qualify for the death-benefit exclusion.
- Line 10(f): The IRS means "transfers" under Code section 414(1) and not direct rollovers which are treated as distributions.
- Line 10(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 earnings on plan investments.
- Line 14: Having additional employees is not necessarily a sign the plan sponsor is doing anything wrong. The IRS

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might check later to see if the plan sponsor has covered this employee properly.

• Line 15(b): The form of payment must be a QJSA (qualified joint and survivor annuity) 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." Examples: 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.

Line 15(c): 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.

Purpose of Schedule P

The purpose of Schedule P is to start the statute of limitations, which means the period of time the IRS can come back and examine the return.

Even though an employer is not required to file a Form 5500, it is still to the employer's advantage to file the Form 5500-EZ. The Schedule P is only filed as an attachment to the Form 5500-EZ, and cannot be sent in by itself.

The Schedule P is signed by the fiduciary (trustee or custodian) of the plan.

Suggestion

If your financial institution does not assist with the preparation of the Form 5500-EZ, then we suggest you send a reminder notice to your business customer that he or she will need to determine if the Form 5500-EZ must be filed. ◆

WHO IS TAXED ON AN IRA DISTRIBUTION: THE IRA ACCOUNTHOLDER OR THE EX-SPOUSE?

The IRS has recently adopted the position that it is the IRA accountholder who is required to include the distribution amount in his or her income even though the IRA accountholder gives or transfers this amount to the ex-spouse. Conversely, the non-accountholder spouse need not include such a distribution in his or her income.

Code section 408(d)(6) provides the tax rule that a transfer of funds from one spouse's IRA to his or her spouse's IRA is not a taxable event (i.e. tax-free) as long as it is pursuant to a divorce or a property settlement. The law does not authorize any other tax-free transfers while the accountholder is alive. Upon the death of the IRA accountholder, a spouse beneficiary does have the legal right to treat the decedent's IRA as his or her own IRA. This is a special type of transfer.

Some divorce attorneys and the divorce parties do not choose to transfer funds from one spouse's IRA to the other spouse's IRA. They choose to have the funds withdrawn from the IRA and then distributed to the other spouse. Until a very recent U.S. Tax court case (Bunney v. Commissioner of Internal Revenue), some had thought that the parties could decide amongst themselves who would be required to include the distribution amount in their income. The general rule of Code section 408(d)(1) is that it is the recipient who must include the funds in his or her income. It is somewhat arguable who the recipient is. For example, a husband withdrew $125,000 from his IRA and transferred $112,000 of this amount to his ex-spouse in exchange for her interest in the family home. This couple did reside in a community property law state. Could he include in his income for federal income tax purposes only $13,000 ($125,000 - $112,000) or was he required to include $125,000? Would it make any difference if he had made sure the divorce decree indicated his wife would have to include the $112,000 in her income?

As mentioned above, the U.S. Tax Court adopted the following rationale for agreeing with the IRS position that the husband, as the IRA accountholder, must include the $125,000 in his income.

IRAs are created under federal law. Such law does not define the accountholder's spouse or ex-spouse to be a qualifying recipient of a distribution. An ex-spouse is not treated as a distributee under Code section 408(g). That is, the law only authorizes distributions to the IRA accountholder while he or she is alive. Distributions to his or her beneficiaries are authorized only after the accountholder's death.

There were numerous reasons why the Court concluded for federal income tax reasons why any community property

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interest of a spouse or ex-spouse would not be recognized. The stated purpose of an IRA is to provide retirement funds for the accountholder and not for a couple. There would be extreme difficulty in applying the rollover and required distribution rules if a spouse was considered to own 50% of the accountholder's IRA. ◆

TAX LIENS AND BENEFICIARY DISCLAIMERS

ROHN R. DRYE, JR. VS. U.S. 528, 1999

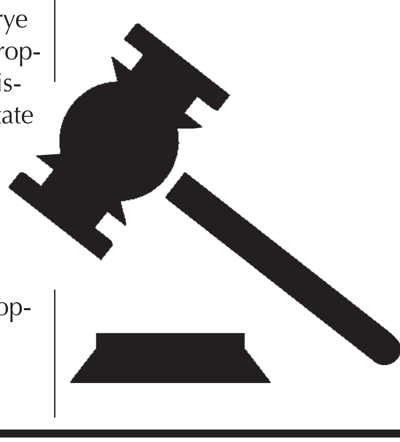
On December 7, 1999, the IRS issued a summary of a tax case which could have application to IRA situations. The main subject of the case is federal tax liens. The IRS printed this case in Internal Revenue Bulletin No. 2000-15 as issued April 10, 2000.

The situation: Rohn Drye, Jr. owed the federal government $325,000 in unpaid tax assessments at the time of his mother's (Irma Drye's) death. He was insolvent at the time. His mother died without a will. Under Arkansas law, her property passed to Rohn Drye. She had an estate of approximately $233,000. The IRS had valid tax liens against all of Drye's "property and rights to property" pursuant to U.S.C. 6321. Arkansas law permits a person to disclaim his or her inheritance whether it arises by will or intestate, and the estate then passes as if he had predeceased his mother. In this case, the property would pass to Rohn Drye's daughter. Arkansas law also provides that the creditors of the person making the disclaimer may not reach the property thus disclaimed. He disclaimed his interest with the hope that his daughter would come to own the $233,000 of property rather than the IRS taking the property to satisfy the federal tax liens which the IRS held against his property.

Did he have any property against which the lien attached? Did his interest to his mother's estate, if any, constitute "property" or a "right to property" to which the federal tax liens attached under 26 U.S.C. 6321, despite his exercise of the prerogative state law accorded him to disclaim the interest retroactively?

No surprise—the IRS wins! The U.S. Supreme Court held that his disclaimer did not defeat the federal tax liens.

The court found Rohn Drye had a type of power. The property was his if he did not disclaim and he understood state law to know to whom it would go if he disclaimed. This power to channel the estate's assets warrants the conclusion that Drye held "property" or a "right to property" subject to the Government's tax liens.



The court also summarized its precedents on similar tax issues as follows: "state law determines whether a given set of circumstances creates a right or interest, federal law then dictates whether that right or interest constitutes "property" or the right to property under section 6321.

CWF Observations

1. In many ways an IRA beneficiary designation is very similar to a designation of a beneficiary under a will or under a state's intestate law.
2. Note that the IRS would not have had a winning claim to the $233,000 if the mother had named her granddaughter as her beneficiary rather than allowing her son to be named by default under the state's intestate laws.
3. If a disclaimer will not work in an estate situation to defeat the IRS, a disclaimer will also not work in an inherited IRA situation.
4. IRAs have been created by federal law and not by state law. State law may not have as much importance as in other property determinations. A strong argument can be made that the IRA plan document should control. ◆

IRS AGAIN ISSUES REVISIONS TO REGULATIONS TO WITHHOLDING OF TAX ON CERTAIN U.S. SOURCE INCOME PAID TO NON-RESIDENT ALIENS

In Internal Revenue Bulletin 2000-23 (June 5, 2000), the IRS issued numerous amendments to the final regulations which relate to the withholding of income tax under section 1441 of the Internal Revenue Code. These regulations are effective January 1, 2001.

In 1997, the IRS announced they were changing the withholding rules which applied to retirement distributions to a foreign person. These withholding rules provided that Code section 1441 would apply to distributions from retirement plans rather than Code section 3405. These withholding rules did not expressly state that they covered distributions from IRAs also. The IRS has amended the final regulation to make it clear that IRA distributions to foreign persons are subject to the withholding rules set forth in Code section 1441 and not Code section 3405.

Set forth below is a general description of what withhold-

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ing is required under section 1441. A subsequent newsletter will discuss what changes in IRA administrative forms will be required because section 1441 will determine the withholding rules which apply to foreign persons rather than section 3405. Current IRA distribution forms and withholding forms have been written to comply with the withholding rules of section 3405. A general description of section 1441 is:

Code section 1441 is titled, "Withholding of Tax on Nonresident Aliens." The general rule is set forth that a payor must withhold from certain defined income types a tax equal to 30%. Again, there are exemptions or exceptions. Some income is only subject to withholding at the rate of 14%. The main exemption is that there is to be no withholding in the case of any income (other than compensation for personal services) which is effectively connected with the conduct of a trade or business within the United States and which is included in the gross income of the recipient under section 871(b)(2). Again, this section does not specifically define IRA distributions as being the type of income subject to withholding at the rate of 30%, but the definition is so broad that the reasonable conclusion is that IRA distributions are subject to withholding at the 30% rate. The withholding required by section 1441 is mandatory, and the recipient does not have the ability to waive it. However, a tax treaty may provide for a lower rate.

The fact that the tax rate and the withholding rate is the same 30% is not a coincidence. Why? A nonresident alien need not file an income tax return if such person was not engaged in a trade or business in the United States at any time during the tax year and if the tax liability for such person was fully satisfied by the withheld tax amount at the source. ◆

IRA CD OR TD HOPPING?

The interest rates being paid for time deposits (TDs) are increasing. CDs (certificates of deposit) is the term which was the equivalent to time deposits a long time ago. As always happens, those IRA accountholders who are age 59 1/2 or older (or age 70 1/2 or older) want to surrender their time deposits paying a lower interest for the newly offered time deposits paying a higher rate. This may be especially true for IRA accountholders who are age 70 1/2 and older. Many believe it is their legal right to do so. It is not. The regulation governing time deposits gives the IRA custodian the discretion (i.e. it is not mandatory) to waive the assessment of the interest penalty for the surrender of a time deposit prior to its maturity when the depositor has attained age 59 1/2 or older, become disabled, or to a beneficiary after the depositor/ accountholder has died.

As has been discussed in this newsletter in the past, more and more financial institutions are no longer willing to allow those accountholders 59 1/2 to 70 1/2 or older to have an unlimited right to exchange an existing time deposit each time the financial institution decides to pay higher rates. Your financial institution should define exactly when your institution will waive the assessment of the early withdrawal penalty and furnish it to your IRA accountholders. The following is a possible policy:

Interest Penalty for Early Surrender of a Time Deposit

The time deposit in which you have invested your IRA assets has an interest penalty which applies when you surrender the time deposit prior to maturity. The amount of the interest penalty is defined in the deposit account information brochure. If you surrender a time deposit prior to its maturity, we will assess you the interest penalty unless you meet one of the following exceptions. The penalty will not be imposed when you are 59 1/2 or older, or if you reinvest the money in another First National Bank retirement account and you have not had any other surrenders for which the penalty was waived within the current calendar year. The penalty will also be imposed if the payment is made on account of your death or disability.

The penalty will also not be imposed if the payment to you is a retirement payment. A retirement payment is one which equals or is less than 30 percent of the IRA account balance at the time of the distribution and you are 59 1/2 or older. A transfer or rollover cannot be a retirement payment. ◆