THE Pension Digest

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ALSO IN THIS ISSUE –

POSSIBLE IRA LEGISLATION

The 106th Congress is close to passing a tax bill which deals almost exclusively with IRAs and pension plan matters. It is called the Comprehensive Retirement Security and Pension Reform Act of 2000 (hereinafter CRS 2000). Time will tell if President Clinton will sign it. He has recently vetoed other tax bills. Many of the law changes (not all) which would be made by this tax bill were contained in the Taxpayer Refund Act of 1999. There is a difference, however. The changes would be effective sooner than they would have been under TRA 99. For various political reasons, President Clinton most likely is more willing to sign this bill at this point in time. Unless stated otherwise, the law changes go into effect as of January 1, 2001.

Increase in Contribution Limit

The IRA contribution limit of $2,000 would be increased for both traditional and Roth IRAs (but an aggregate limit applies) to $3,000 for 2001, $4,000 for 2002, and $5,000 for 2003 and thereafter for taxpayers who are younger than age 50. For taxpayers who are age 50 or older, the limit would be $4,500 for 2001, $6,000 for 2002, and $7,500 for 2003 and thereafter.

There would also be a cost-of-living adjustment authorized. The $5,000 will be multiplied by the cost-of-living factor determined under section 1(f)(3). If the amount after adjustment is not a multiple of $500, then the amount shall be lowered to the next lower multiple of $500.

Increase in AGI Limits for Traditional IRAs

There would be a partial elimination of the "marriage penalty" with respect to the traditional IRA. Under current law, there are generally three categories for determining what portion of a contribution a taxpayer is entitled to deduct: (1) married filing jointly; (2) married filing separately; and (3) single and other filers. Under the Comprehensive Act there would only be two categories: married filing jointly and all other filers. This change would be very beneficial for those married individuals filing a separate tax return.

There would be an increase in the adjusted gross income limits for most active participants. This change would allow an individual to deduct more of his or her contribution. Set forth in **Table A** is a comparison of the applicable dollar amounts for a taxpayer who files a joint return.

TRA 1999 would have provided for an additional increasing of the $80,000 limit to $91,000 over a three-year period, but this change was deleted from CRS 2000.

Set forth in **Table B** is a comparison of the applicable dollar amounts for all other filers. Under TRA 1999, this change would not have

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Table A

Tax Year	Current Law	Proposed CRS 2000	Change
2001	$53,000	$56,000	+$3,000
2002	$54,000	$60,000	+$6,000
2003	$60,000	$64,000	+$4,000
2004	$65,000	$68,000	+$3,000
2005	$70,000	$72,000	+$2,000
2006	$75,000	$76,000	+$1,000
2007 or thereafter	$80,000	$80,000	None

Table B

Tax Year	Current Law	Proposed CRS 2000	Change
2001	$33,000	$36,000	+$3,000
2002	$34,000	$40,000	+$6,000
2003	$40,000	$44,000	+$4,000
2004	$45,000	$48,000	+$3,000
2005 or thereafter	$50,000	$50,000	None

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applied to those married individuals who filed a separate return, but this change under CRS 2000 does apply to such married individuals.

Here, too, TRA 99 would have provided for an additional increasing of the $50,000 limit to $57,000 over a five-year period, but this change was deleted from CRS 2000.

Roth IRA Changes

As with the changes for the traditional IRA, the law would be modified to lessen the marriage penalty associated with a Roth IRA. There would be two principal changes.

First, everyone knows about the infamous $100,000 limit. A married couple was subject to the same limit $100,000 as a single person, and consequently many married individuals were not eligible to convert funds from his or her traditional IRA to a Roth IRA. Under CRS 2000, the $100,000 is increased to $200,000 in the case of a joint return. Remember that under current law, a married individual who files a separate return is not eligible to do a conversion. This rule would continue to apply.

Second, under current law, there are three categories to determine an individual's ability to make a contribution to a Roth IRA—married filing a joint return; married filing a separate return; and all other filers. Under CRS 2000, there would be just two filing categories—married filing jointly, and all others. That is, a married person filing separately would have a phase-out range of $95,000-$110,000 rather than 0 to $10,000.

Under current law, the AGI phase-out range for a single person making a Roth IRA contribution is $95,000 - $110,000. Under current law, the AGI phase-out range for making a Roth IRA contribution for a married person filing a joint return is $150,000-$160,000. In order to eliminate the marriage penalty, CRS 2000 would authorize (for a married person filing jointly) an AGI phase-out range of $190,000 - $220,000.

Certain employer-sponsored plans would be authorized to accept annual traditional IRA contributions and/or Roth IRA contributions. At this time, it appears the only type of employer plan which would qualify is a section 457 plan. This provision would be effective as of January 1, 2002.

New Distribution Rules for Charitable Distributions

CRS 2000 would authorize certain individuals to withdraw funds from their IRAs and then have the withdrawal amount paid to certain qualifying charitable organizations without having to include the amount distributed in his or her income. Under current law, a similar tax result may only be achieved if an IRA accountholder designates a charitable organization as his or her beneficiary. Upon the death of the IRA accountholder the charitable organization will not pay tax on the amount distributed from the IRA.

Why wait? Under CRS 2000, the charitable organizations will be able to receive IRA funds without requiring the giver to have to pay income tax. Remember that the IRA accountholder most likely received a tax deduction for his or her contribution.

In order to receive such favorable tax treatment, the distribution must be a "qualified charitable distribution," which means any distribution from an IRA which is made on or after the date the IRA accountholder has attained age 70 1/2, and which is a charitable contribution made directly from the account to an organization described in section 170(c) or certain charitable remainder trusts, pooled income funds, and charitable gift annuities. The general rule is that there will be no inclusion in income, but there are exceptions.

The SIMPLE-IRA Changes

The law would be changed to allow certain employers to sponsor a "salary reduction only" SIMPLE-IRA plan. That is, an employer would not be required to make a matching contribution.

The $6,000 contribution limit would be increased by two law changes.

First, there would be an increase in the deferral limit with respect to elective deferral amounts under a SIMPLE-IRA plan.

Tax Year	Current Law	Proposed TRA 99	Change
2001	$6,000	$7,000	+$1,000
2002	$6,000	$8,000	+$2,000
2003	$6,000	$9,000	+$3,000
2004 or thereafter	$6,000	$10,000	+$4,000

Second, catch-up contributions to a SIMPLE-IRA plan (i.e. increased elective deferrals) would be permitted for individuals age 50 or over. The individual must attain age 50 before the close of the year. There would be a limit as to the amount of these catch-up contributions. They cannot exceed the lesser of: (1) the applicable percentage, or (2) the excess of an individual's compensation over any other elective deferrals he or she would make. This limit appears reasonable—an individual should not be able to defer more than his or her compensation. The applicable percentage would be:

For Taxable Years Beginning In Year	Standard Contribution Limit as Proposed	Applicable Percentage Age 50 or Over	Adjusted Contribution Limit Age 50 or Over
2001	$7,000	150%	$10,500
2002	$8,000	150%	$12,000
2003	$9,000	150%	$13,500
2004 or thereafter	$10,000	150%	$15,000

Major Changes in RMD Rules

There would be numerous changes in the minimum distribution rules. The intent is to simplify and update these rules.

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The first change is that the Secretary of the Treasury will be required to finalize the regulations.

Such regulations shall be effective for years beginning after December 31, 2000, and shall apply in such years without regard to whether an individual had previously begun receiving minimum distributions.

The regulations are to be modified to reflect increases in life expectancy and revise the required distribution methods so that, under reasonable assumptions, the amount of the required minimum distribution does not decrease over a participant's life expectancy.

All taxpayers and beneficiaries currently subject to the current RMD rules would be given the right to have a fresh start during the first year that the revised regulations apply. Required distributions for future years may be redetermined. The accountholder shall have the right to designate a new beneficiary and to elect a new method of calculating life expectancy.

In addition, there would be a repeal of the rule requiring the remaining portion of an accountholder's remaining IRA funds to be distributed at least as rapidly as under the method of distribution being used as of the date of death. The effect of this change would be that the five-year rule and the life-distribution rule would apply whether the accountholder dies before or after his or her required beginning date.

New Tax Credit For Low- and Middle-Income Savers

CRS 2000 would create a new tax credit. A tax credit is usually more beneficial than a tax deduction. The credit would be available with respect to elective contributions to plans with elective deferrals features, contributions to a traditional or Roth IRA and voluntary after-tax employee contributions to a qualified retirement plans. The maximum annual contribution eligible for the credit would be $2,000.

The credit rates would be based upon AGI (of course) as shown in **Table C.**

This credit would be available for tax years 2001-2005. It would be in addition to any deduction or exclusion that would otherwise apply with respect to the contribution. The credit would be allowed to offset minimum liability as well as regular tax liability.

An individual is eligible for this credit if, in addition to the above AGI limit, he or she is age 18 or over but has not attained age 60; he or she cannot be a full-time student or be claimed as a dependent on another taxpayer's return.

The amount of any contribution eligible for the credit would be reduced by taxable distributions (except all distributions from a Roth IRA) received by the taxpayer and his or her spouse from any savings arrangement during the taxable year for which the credit is claimed, the two taxable years prior to the year the credit is claimed and during the period after the end of the taxable year and prior to the due date for filing the taxpayer's return for the year.

Rollovers of IRAs into Workplace Retirement Plans

The concept of conduit IRAs would be repealed. Any funds within an IRA would be eligible to be rolled over into an eligible retirement plan as defined by clauses (iii), (iv), (v), and (vi) of section 402(c)(8)(B).

A SIMPLE-IRA may only be rolled over to another SIMPLE-IRA until the two-year requirement has been met.

The above rollover rules would apply to distributions made after December 31, 1999.

Rollovers of After-Tax Employee Contributions

It may have taken 14 years, but the law would finally be changed to allow the rollover of after-tax employee contributions into an IRA. It was TRA 86 which brought the concept of nondeductible IRA contributions.

From a logic standpoint, once there could be nondeductible contributions to an IRA, it should have been possible to roll over after-tax employee contributions from a qualified plan and simply add them to the nondeductible IRA contributions.

Special Relief for Certain Rollovers

For a long time, the IRS has held to its position that no matter how egregious the situation, the IRS did not have any authority to allow a rollover when the 60-day requirement had not been complied with. The IRS will now have such authority. The Secretary of the Treasury may waive the 60-day requirement when failure to do so would be against equity or good conscience, including casualty, disaster, or other events beyond the reasonable control of the individual subject to such requirement. This rule change would apply to any distribution which could be rolled over from an IRA, qualified plan, 403(b), or any other plan which may be rolled over subject to the 60-day rule. This change would be effective for 60-day periods ending after the date of enactment of this Act. ◆

Table C

Joint Filers	Heads of Household	All Other Filers	Credit Rate	Maximum Credit
0-$30,000	0-$22,500	0-$15,000	50%	$1,000
$30,001-$40,000	$22,501-$30,000	$15,001-$20,000	25%	$500
$40,001-$50,000	$30,001-$37,500	$20,001-$25,000	5%	$100
Over $50,000	Over $37,500	Over $25,000	0%	0

SUMMARY OF PROPOSED QUALIFIED PLAN CHANGES

1. Increase in dollar limits. The defined benefit limit of $90,000 would increase to $180,000. The defined contribution limit of $30,000 would increase to $45,000.

2. The annual compensation limit of $150,000 (as indexed and currently at $170,000) would be increased to $235,000.

3. The maximum elective deferral limit of $7,000 (as indexed and currently at $10,000) would be increased to $15,000.

4. Plan loans would be permissible for subchapter S owners, partners and sole proprietors, but still not for IRAs.

5. There would be numerous changes in the top-heavy rules. The family aggregation rules would be repealed. The definition of who is a key employee would be simplified. The two most significant changes would be—employee elective deferrals need not be take into account, and matching contributions may be taken into account for minimum contribution requirements.

6. With respect to calculating an employer's deduction for contributions to a 401(k) plan, elective deferrals shall not be taken into account.

7. A 401(k) plan shall be treated as meeting the nondiscrimination requirements if such arrangement constitutes an automatic contribution trust (ACT). An ACT means a plan under which each employee eligible to participate is treated as having elected to have the employer make elective contributions in an amount equal to the uniform percentage (not less than 3 percent) of compensation provided under the plan until the employee specifically elects not to have such contributions made and which meets certain other requirements.

8. The definition of compensation would again be changed. Compensation is as defined in section 414(s) or constitutes base pay. Base pay means a reasonable definition of compensation that does not, by design, favor highly compensated employees and that excludes, on a consistent basis, all irregular or additional compensation.

9. The deduction limit for stock bonus and profit sharing plans would be increased from 15% to 25% of compensation.

10. There would be an option to treat elective deferrals as after-tax contributions. This would be called either the qualified plus contribution program or the Roth 401(k) program. Rules very similar to the Roth IRA taxation rules would apply. Obviously, separate accounting would be required. Funds could be rolled from a Roth IRA to such a 401(k) plan or vice versa.

11. A credit would be given small employers with respect to the startup costs to establish a pension plan. The credit would be 50% of the actual cost, but not to exceed $1,000 for the first year and $500 for the next two years. An employer would not be eligible for the credit if a plan was not in service in 1998.

12. Catch-up contributions would be permitted for those attaining age 50.

13. The annual limit of $30,000 would be increased to $40,000.

14. There would be faster vesting for employee matching contributions—either a three-year cliff or 20% per year for five years.

15. The RMD rules would be changed as previously summarized for IRAs.

16. There would be numerous changes in the rules to make it easier to roll over funds between the various types of retirement plans and IRAs. Plans will have to have the accounting mechanisms to have separate accounting when necessary. The main change is that section 457 funds will be able to be rolled over to IRAs, qualified plans, or section 403(b) plans.

17. The rollover of IRAs into workplace retirement plans would be authorized.

18. It would become permissible to roll over after-tax contributions. Presumably this would be from, or to, a plan or IRA.

19. The IRS would be given the authority to waive the 60-day requirement with respect to a rollover if the failure to do so would be against equity or good conscience.

20. There would be additional changes in the anti-cutback rules.

21. There would be additional changes in the same-desk rules.

22. Funds in 403(b) plans and 457 plans could be used to purchase credit in governmental defined benefit plans without the taxpayer having to include the amount so used in income.

23. The law would be changed to allow the plan administrator to disregard any rollovers in determining whether or not the $5,000 amount existed for purposes of applying the cash-out.

24. A plan administrator will be able to elect to transfer to the PBGC a missing participant's benefits upon the termination of the plan. That is, an employer will be able to finally terminate a plan by shifting to the PBGC all those problems which arise with missing participants.

25. There would now be civil penalties for breach of fiduciary responsibility. The penalty would be at the discretion of the judge.

26. In certain situations a plan administrator must provide a notice for certain reductions in benefit accruals.

27. Sanctions other than disqualification would be created.

28. The 401(k) multiple-use test would be repealed.

29. There would be a number of changes in the nondiscrimination rules.

30. ESOP dividends may be reinvested without loss of dividend deduction.

31. The notice and consent period regarding distributions would be changed. Rather than the current 90-day period, the period would change to be one year.

32. The providing of retirement planning services by an employer to employees

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Summary of Changes,
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shall be treated as a de minimis fringe as long as certain rules are met.

33. A plan will be treated as being operated in accordance with the terms of the plan during the period described in subsection (b)(2)(A) and such plan will not fail 411(d)(6) because of such amendment. This rule applies to an amendment adopted on or before the last day of the first plan year beginning on or after January 1, 2002.

34. There will be simplified reporting for one-person plans. There will be no need to file if the plan had assets of $500,000 or less as of the close of the plan year.

35. The IRS will be required to write and publish a model defined contribution plan and a defined benefit plan that fits the needs of small businesses. The deadline is 12-31-2000. However, the IRS may satisfy this requirement by enhancing and simplifying the prototype program. ◆

QUALIFIED PLAN AMENDING

As you may or may not be aware, all qualified plans need to be amended by December 31, 2000. Please be assured that CWF (and consequently your institution) are not late with respect to amending qualified plans which have been established by using CWF's prototypes.

In February of 2000, the IRS issued Rev. Proc. 2000-20. It is permissible for CWF to submit our rewritten prototypes to the IRS any time from April 7, 2000 to December 31, 2000. We have waited until now, because it has been our past experience that the IRS normally issues new regulations and other rulings, which would be desirable to incorporate into the revised plan documents.

The purpose of this article is to summarize the Amendment and Restatement process. However, it should be remembered that the changes in the statutory law and published regulations over the over last 9 years have made only very minor changes with respect to one-person profit sharing or money purchase plans. Admittedly, the changes for plans with participants other than the owner have been quite substantial.

Requirement to Amend Qualified Plan Prototypes and the Plan(s) of an Adopting Employer.

A business entity (including a one-person business) which currently sponsors a qualified plan(s) must amend and restate its qualified plan(s).

The deadline for doing so depends on whether the business' qualified plan exists because a prototype plan as sponsored by a bank or insurance company was executed, or because the employer has an individually-designed plan. In general, all qualified plans must be amended and restated to comply with numerous law changes which have taken place since 1993.

What Will Collin W. Fritz and Associates, Ltd. be Doing?

We are a mass submitter of QP prototypes. We must submit our rewritten prototypes to the IRS no later than December 31, 2000. We are presently rewriting our six prototypes and expect to be finished by October 22, 2000. We must submit our rewritten prototypes along with applications for ourselves and for each institution using our prototypes to the IRS no later than December 31, 2000.

We will confirm to all users of CWF's prototypes that we have made our filing and the filing for each institution and when we did so.

What Will Current CWF Prototype Users (i.e. The Adopting Financial Institution) Need to do?

a. They will need to decide what prototypes they want us to file with the IRS on their behalf. We will be sending our prototype users a letter soon, listing the prototypes the institution currently has, and describing our new prototypes. We will assume the institution wants the "equivalent" prototypes, unless CWF is instructed otherwise.

b. They will need to sign a "power of attorney" form (Form 2848) and return it to CWF. This form authorizes us to complete and submit the application forms on the institution's behalf and then make the filing.

c. Enclose a check to Collin W. Fritz and Associates, Ltd. to cover the IRS filing fees — $110 per adoption agreement.

d. After the IRS issues the institution a favorable opinion letter (should be 3-6 months after we submit) the institution will then need to work with its customers to have them sign the revised adoption agreements. Although the law gives a deadline (see below), it will be best if this is accomplished as soon as possible.

What Will an Institution's Business Customer Need to do?

An institution's business customer has until the last day of the 13th month which follows the month the IRS issued the financial institution its favorable opinion letter to execute a revised adoption agreement. That is, if the IRS issued the favorable opinion letter on 4-7-01, then the institution's business customers must amend and restate their plan(s) on or before 5-31-02. ◆

PERMISSIBILITY OF USING IRA FUNDS TO BUY BACK PENSION CREDITS/SERVICE

CWF has been asked to discuss the following situation.

A bank has an IRA accountholder who has asked to roll over or transfer her IRA to MERS. MERS is the Municipal Employees' Retirement System of Michigan.

Jennifer L. Willis, a retirement specialist with MERS, wrote the IRA accountholder a letter on August 29, 2000. The purpose of the letter was to cover the procedures which needed to be followed in order for the IRA accountholder to purchase "five years and two years six months of generic service time at Ogemaw County."

In her letter, Ms. Willis states, "You may roll over any IRA or a taxable certificate of deposit to purchase service time." We do not believe this statement was explained as well as it could have been. We believe what she meant to say was—an IRA may be used as the source of the cash to be used to buy back the service time, as may a nonIRA certificate of deposit.

The term "roll over" has a very specific meaning for income taxation purposes. The general rule is that when a person withdraws money from an IRA or uses the money in an IRA for personal benefit, as would be the case in this buy-back situation, then the person will need to include the involved amount in income for federal income tax purposes. However, a rollover is one of the exceptions to this general rule. If funds are properly rolled over, then the distribution is not included in income.

We do not have the information to know if the involved IRA is a conduit IRA or not. A conduit IRA is an IRA which has received a rollover from a qualified plan or 403(b) plan and the funds have not been commingled with other types of IRA funds.

If the IRA is a conduit IRA, then it may be used to buy service without the person having to include the amount in income, because a person is able to roll funds from a conduit IRA to a 401(a) pension plan.

If the IRA is not a conduit IRA, then the person may use it as the source of funds to buy the service, but the person will need to include such amount in income for federal income tax purposes and pay tax on such an amount because it does not qualify to be rolled over.

The remainder of this article discusses two possible administrative approaches if the IRA is not a conduit IRA.

First, the bank could issue the check to the accountholder for the full amount or whatever amount she instructed. She in turn would write her own check to MERS. We believe this would be the best approach, as she is required to enclose a "signed resolution" with the check. We are not so sure it is best for the bank to assume the role of sending the required documents to MERS. The accountholder would need to complete a standard IRA distribution form. Please note that she would be subject to the 10% additional tax of Code section 72(t) if she has not attained age 59 1/2, unless an exception would apply. Using funds to buy back service credit is not one of the exceptions. As you know, the bank is required to prepare a 2000 Form 1099-R to report to the accountholder and the IRS the distribution amount.

Second, the bank could adopt an approach of being more customer friendly by issuing a check to MERS and possibly sending the other required documents also. But the bank will still need to prepare a 1099-R form for the accountholder.

For your information, there is currently a tax bill in Congress (Comprehensive Retirement Security and Pension Reform Act of 2000) which may allow the accountholder to buy back this past service credit with her IRA funds without having to include the amount in her income. This bill would allow rollovers from IRAs to pension plans. We do not believe the bill expressly discusses the situation of using IRAs to buy past service. More research would be necessary. The bill would allow funds to be moved from a 403(b) plan or a section 457 plan to buy service, and the individual would not have to include the amount in income.

Such new rules, if enacted, will apply to any distribution occurring after December 31, 1999. That is, it would apply to any distribution which is rolled over (i.e. withdrawn and recontributed). The accountholder may well want to discuss this with her tax advisor, as the law may be changed. ◆

CLINTON VETOES FEDERAL ESTATE TAX BILL

VETO

On August 31, 2000, President Clinton vetoed a bill which would have repealed the federal tax laws dealing with estate and gift taxes. Over a ten-year period the applicable taxes would have been gradually reduced to the point where there no longer would have been a tax imposed on estates and gifts. Under existing law, an individual must include all IRAs and pension balances in his or her estate for federal estate tax purposes to see if a

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THE EFFECT OF DIVORCE ON A SUBSTANTIALLY EQUAL PERIODIC PAYMENT SCHEDULE(S)

More and more accountholders are establishing substantially equal periodic payment schedules so that they receive distributions prior to age 59 1/2 and yet not owe the 10% additional tax. More and more accountholders are also divorcing. The following question will be arising, "How does divorce affect an IRA accountholder/taxpayer who has an IRA and who has established a substantially equal periodic payment schedule, but whose spouse now wants his or her 50%?"

This is a "be careful" area for IRA accountholders and IRA custodians/trustees. The law is certainly not settled.

Code section 72(t)(1) imposes a 10% additional tax on certain distributions from IRAs and pension plans. Code section 72(t)(2) defines certain exceptions when the 10% additional tax will not be owing.

One of those exceptions is for substantially equal periodic payments as defined in section 72 (t)(2)(A)(iv). It provides that the 10% tax will not apply to a distribution which is "part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of such employee and his designated beneficiary." The statute does not define when a distribution is part of a series of substantially equal periodic payments. The IRS has given limited guidance. The IRS issued Notice 89-25 wherein the IRS furnished three safe harbor methods (the 401(a)(9) method, an amortization method, and an annuity factor method) which would qualify as part of a series of substantially equal periodic payments.

Current law contains a recapture provision which applies to an accountholder who establishes a series of substantially equal payments and then modifies this series before the law permits. This special recapture tax is authorized by Code section 72(t)(4)(A)(ii)(II) and applies if the substantially equal periodic schedule is subsequently modified other than by reason of death or disability. In general, the special recapture tax is 10% of the previous distributions for which the 10% tax was not paid, plus interest on such amounts accruing from the time the payments would otherwise have been made.

Divorce is not expressly listed as a permissible reason for modifying a substantially periodic payment schedule. Maybe it should be, but it is not under existing law. To what degree the IRS will choose to be nice is not clear. Thus, it appears that the 10% additional tax would be owing if a distribution schedule to an IRA accountholder is modified as a result of a divorce.

An IRA custodian/trustee is to use reporting code "2" on the Form 1099-R when there is a distribution which qualifies as a series of substantially equal periodic payments and a reporting code "1" when there is an improper modification of the schedule.

When an accountholder sets up a series of substantially equal periodic payments pursuant to the amortization method or the annuity factor method, it is important to note that the amount distributed each year is a constant and does not change except as permitted by a cost-of-living adjustment, if any. In contrast, when an accountholder sets up a series of substantially equal periodic payments pursuant to the 401(a)(9) method, the annual amount will change each and every year because the December 31 balance changes as does the life-expectancy factor.

So, can the schedule be modified as a result of a divorce so that the accountholder who established the schedule will not owe the 10% recapture tax?

The conservative answer is "no." However, see the discussion of PLR 9739044 provided later in this article.

The conservative approach should be followed if the schedule being used was either the amortization or the annuity factor method. At this time there is no written authority from the IRS supporting a change in these two methods. This means an IRA accountholder who has established a substantially equal periodic payment schedule is justified (and even required) to take the position that he or she is not permitted to take less than the original calculation amount or he or she will owe the recapture tax calculated pursuant to 72(t)(4)(A)(ii)(II). Note that if the remaining funds (after 50% has been transferred to the ex-spouse) within the IRA will be depleted before permissible, the IRS would very likely argue that the recapture tax calculated pursuant to 72(t)(4)(A)(ii)(II) would apply. And even though the accountholder who has transferred the 50% may wish to be paid less than he or she was being paid, again this should not be done. The IRS would argue the recapture tax calculated pursuant to 72(t)(4)(A)(ii)(II) would apply.

However, there is at least one PLR 9739044 (July 1, 1997) wherein the IRS ruled that an impermissible modification did not take place, and therefore the additional 10% was not owing, when there was a transfer of IRA funds incident to a divorce and a simultaneous decrease in the transferor's IRA balance and distribution amount.

Here is a summary of PLR 9739044. Taxpayer A, age 55, had established a substantially equal periodIc payment schedule. Taxpayer A and Taxpayer B (age 53) were in the process of a divorce. They agreed as follows: Taxpayer A would transfer 50% of his IRA's to Taxpayer B. Taxpayer A would continue to receive a substantially equal periodic payment distribution, but obviously much less as his balance was one-half of what it had been. Note that this means the 401(a)(9) method was the method being used, and not the annuity factor or amortization

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method. Taxpayer B agreed to also have a substantially equal periodic distribution using her age. The change in the combined payment amounts to both of them was going to be substantially the same as had been paid to him. The IRS ruled that there was a nontaxable transfer pursuant to section 408(d)(6) and that the reduction in his account balance on account of such transfer and the reduction of the scheduled distribution amount will not result in imposition of the 10% additional tax as calculated pursuant to 72(t)(4)(A)(ii)(II).

Summary. Until the IRS issues more written guidance, an IRA custodian/trustee, for IRA reporting purposes, should adopt an administrative approach that a change in a substantially equal periodic payment schedule because of a divorce will be subject to the 10% recapture tax. An IRA custodian/trustee may well wish to notify the account-holder that it is possible the IRS may determine otherwise if asked. ◆

QA QUESTIONS AND ANSWERS

YOU CALLED WITH THE FOLLOWING SITUATION. AN EMPLOYER HAS ESTABLISHED A SIMPLE-IRA PLAN BY EITHER SIGNING THE IRS MODEL FORM 5305-SIMPLE OR THE IRS MODEL FORM 5304-SIMPLE.

HOW SHOULD THE BANK HANDLE THE SIMPLE-IRAS OF TERMINATED EMPLOYEES? MUST THE EMPLOYER PAY THE FEES FOR THE TERMINATED EMPLOYEES? YOU HAVE ASKED US TO DISCUSS.

We don't believe whether the Form 5305-SIMPLE or the Form 5304-SIMPLE was adopted affects the answer to your question/situation. However, the general rule found in the IRS Model Form 5305-SIMPLE is that each participant must have the right to transfer his or her account balance without cost or penalty. Be aware the IRS has limited this rule. Such a "no cost for transfers" rule does not exist if the Form 5304-SIMPLE was executed.

Once the employer has chosen between the Form 5305-SIMPLE or the Form 5304-SIMPLE, then each employee must establish his or her own SIMPLE-IRA.

As is evident, a SIMPLE-IRA is very different from a traditional IRA—there is a third party involved, the employer. Since the SIMPLE-IRA plan is a type of pension plan, it is quite common for an employer to agree to pay certain administrative fees as is often done with other types of pension plans.

In your situation, the employer agreed to pay certain administrative fees of ABC Bank. We are not totally clear about what fees are being charged for what services. We believe there are limits as to which fees an employer may pay. For example, the employer could not directly pay any separate brokerage fees.

In the current situation, the employer is very willing to pay certain fees for its current employees, but does not want to pay such fees for the employees who have separated from service.

As you know, an individual's SIMPLE-IRA is not eligible to be transferred or rolled over until a two-year requirement has been met. The two-year period commences when the participant first participated in any SIMPLE-IRA plan of the employer. There is no special rule for employees who separate from service. That is, no relief is given from the "no rollover" or "no transfer" rule just because an employee has separated from service. This means ABC Bank will be serving as the SIMPLE-IRA custodian/trustee for a certain number of "terminated" participants.

We believe the ability of ABC Bank to charge fees for services rendered with respect to SIMPLE-IRAs is primarily a contractual matter.

The general rule is that an IRA custodian/trustee will require that such fees be paid by the IRA itself. We see no reason why this same rule does not apply to SIMPLE-IRAs. There is no law which requires an employer to pay such fees. In some limited situations an IRA custodian/trustee of a traditional IRA may allow a sponsoring employer to pay the fees.

Conclusion. We believe it is permissible for an employer to adopt a policy that it will NOT pay the administrative or trustee SIMPLE-IRA fees for those employees who have separated from service. The question remains for the bank, "Will it find the employer's unwillingness to pay such fees acceptable?" The bank will need to coordinate its SIMPLE-IRA disclosures and contracts to define when its fees will be paid by the employer and when they will be paid by the individual's SIMPLE-IRA. ◆