THE Pension Digest

February 2002
Published Since 1984

ALSO IN THIS ISSUE –



**Collin W. Fritz and Associates, Inc.,**
***"The Pension Specialists"***



## Still Waiting for Issuance of IRA Model Forms

The IRS has announced that they intend to issue their revised model forms on March 7, 2002. This is the stated target date. We would not be surprised if this date is missed also. CWF and Associates will have available revised IRA Plan Agreements and revised IRA Disclosure Statements and the related IRA Amendments in 10-20 business days thereafter.

## Still Waiting for Finalization of RMD Regulation and New Life Expectancy Tables

It is the end of February 2002, and the IRS still has not finalized the RMD regulation. We expect this regulation to be finalized any day. The IRS has stated in various IRS publications (e.g. Publication 590) that many of the rules, as proposed, will be used for 2002 and subsequent years.

The IRS will be issuing new life expectancy tables as EGTRRA mandates the issuance of new tables. It is not clear if there will be two revised tables – Single Life and Joint Lives or if there will be three revised tables – Single Joint and MDIB table. As is well known, the IRS created the MDIB table by coming up with hypothetical joint life expectancy factors by using the following ages 70/60, 71/61. 72/62, 73/63, 74/64, 75/65, 76/ 66, 77/67, 78/68 etc.

## Changes in Taxation and Rollover Options Before and After EGTRRA

The purpose of this article is to illustrate that EGTRRA has brought some significant changes in the tax rules applying to qualified plan (QP) distributions. The rules which apply in 2002 are not the same rules which applied in 2001. QP recipients and IRA custodians need to understand the new rules.

The major change made by EGTRRA is that it is now mandatory that a QP participant has the right to roll over nondeductible contributions, if any, from a QP to an IRA.

**Continued on page 2**

## Why so Few Rollover Options for SIMPLE-IRA Plans?

EGTRRA brought many rules changes making it easier for participants of certain employer plans to roll over funds to a traditional IRA and then also to roll over funds in an IRA to certain employer plans. EGTRRA defined these plans to be 401(k) plans, profit sharing plans, money purchase plans, ESOP plans, qualified annuity plans, section 403(b) plans and section 457(b) plans. There has been talk for years in Congress that participants should be able to move their retirement funds more easily from one employer plan to another employer plan.

An employer was first authorized to establish a SIMPLE-IRA plan as of January 1, 1997. This was a new type of employer-sponsored retirement plan. It's basic features are: the employees were permitted to make elective deferrals; the owner or highly compensated employees of the employer did not have to worry about satisfying any ADP/ACP tests as long

**Continued on page 8**

**Changes in Taxation,**
**Continued from page 1**

Some may view this change as a positive, as they will now have the right to continue to have tax-deferred earnings on the nondeductible contributions under an IRA, as they had under the QP. Others may view this change as a negative because a participant will no longer be able to withdraw one's nondeductible account balance and then roll over the taxable portion as could be done when it was not permitted to roll over the nondeductible contributions.

The following situation illustrates the effect of the rule changes. An individual was a participant in a 401(k) plan. He separated from service in 2001. The individual had an account balance of approximately $345,000, with approximately $4,800 attributable to nondeductible contributions. Although the 401(k) plan document stated that a participant entitled to distributions was not eligible to roll over the nondeductible portion of the account balance (i.e. $4,800), nevertheless, his entire account balance of $345,000 was rolled over into an IRA with ABC Bank as the IRA custodian, sometime in 2002.

The participant wishes the rollover amount would have been $340,200, and that the $4,800 was paid to him, because he would have owed no tax with respect to the $4,800. Could this be the result for 2002? The answer is "no." Could this have been the result in 2001? The answer is "yes. "

The IRS has made very clear that pension plans are not required to be amended to authorize the acceptance of such rollovers. However, the law does require such plans, as the paying plan, to be amended to authorize the rollover of nondeductible contributions. Therefore, this individual or the plan cannot argue that the rollover should be able to be reversed because the plan document had not yet been changed to authorize the rollover of nondeductible contributions.

In conclusion, what this individual wished to have had happen, would have been possible before January 1, 2002, but not after. It would have been best if the distribution and rollover of the deductible/taxable amount had occurred in 2001.

An IRA accountholder must also be aware that EGTRRA may have created a planning tool, also. If he or she would be eligible and could find a qualified plan which would accept his or her rollover of certain IRA funds, then he could accomplish the following result. EGTRRA prohibits the rolling of basis within an IRA into a qualified plan. Thus, he would be eligible to roll over only $340,200. He could roll over this amount. This would mean, then, that he would have $4,800 in his IRA. This amount would all be non-taxable basis, and thus could be withdrawn tax free. After the $4,800 was withdrawn, he could roll over such QP funds into another IRA, and the funds would now not have any basis. A person may well wish to establish a Keogh or profit sharing plan for this purpose. The person would be required to comply with all rules governing the establishment of such a plan.

The following is a summary of the distribution options which a QP participant has.

## The PRE-2002 Rules

A participant had three options:

(1) Receive a total distribution of cash and/or property which is not employer stock. To the extent the distribution is eligible to be rolled over, the payor is mandated to withhold 20% of the gross distribution amount. To the extent the distribution is ineligible to be rolled over, the payor is required to withhold 10% of the gross distribution amount, but the recipient may instruct to have an additional amount withheld or to have no withholding.

The following formula is used to figure the tax-free amount of the distribution:

Amount Received x (Cost of Contract/Account Balance) = tax-free amount. Total amount less tax free amount = taxable amount.

However, there are two special rules which may apply. A determination must be made as to what extent, if any, these special rules apply.

The first special rule applies if a participant contributed nondeductible employee contributions before 1987 to a plan that, as of May 5, 1986, permitted the participant to withdraw such contributions before the participant separated from service. In such case, the distribution(s) to the participant are tax-free to the extent that the distribution(s), when added to any other distributions after 1986, do not exceed such cost as of December 31, 1986. This rule would not apply because the participant had separated from service.

The second special rule applies if the employee participates in a defined contribution plan. This special rule allows the participant to treat his nondeductible employee contributions (and the allocable income) as a separate contract for purpose of figuring the tax-free portion (and the taxable portion) of any distribution.

This second rule is used by many participants, but it does require that the administrator has allocated gains and losses properly to the $4,800 of nondeductible contributions. For illustration purposes it is assumed that there has been $10,000 of earnings with respect to this $4,800. If this participant would now withdraw $8,000, then the tax result would be as follows: tax-free portion of the distribution equals $8,000 times $4,800/$14,800 and not $8,000 times $4,800/$385,000. The tax-free amount is $2,594 and the taxable amount is $5,406 ($8,000-$2,594).

Tax-free portion = $4,800 x $4,800/$14,800, and not $385,000 x $4,800/$385,000.

**Continued on page 3**

The Pension Digest

**Changes in Taxation,
Continued from page 2**

(2) Directly roll over the amount of the total distribution. This distribution will not be taxed because of the rollover.

(3) Do a combination of (1) and (2). The participant in some cases, will not be eligible to roll over a portion of the distribution. For example, a participant was NOT eligible to roll over the remaining amount of his nondeductible employee contributions. In other cases, he will not want to roll over the entire amount even is it is eligible to be rolled over.

The application of this rule meant that the individual was allowed to be distributed his $4,800 tax free. That is, the pro rata taxation rule was not applied as long as he rolled over the entire portion of the distribution which was eligible to be rolled over.

## Taxation After EGTRRA (2002 Rules)

EGTRRA did not change the approach of the law. The participant has the same three options.

However, in 2002 the pro rata distribution rules will actually apply since he no longer can receive a distribution of the nondeductible contribution account balance of $4,800 and roll over the remainder.

# From the IRS

## Frequently Asked Questions Regarding Required Minimum Distributions and the New Proposed Regulations

1. **Question —** Are there new rules for calculating required minimum distributions from qualified retirement plans and individual retirement arrangements (IRAs)?

   **Answer —** Yes. The new 2001 proposed regulations which were published in the Federal Register on January 19, 2001, provide the rules that can be used to calculate minimum required distributions under qualified plans and IRAs for calendar years beginning on or after January 1, 2001. In particular, the new 2001 regulations significantly simplify the required distribution rules applicable to defined contribution and other individual account plans. The rules for calculating required minimum distributions from qualified plans under section 401(a)(9) of the Internal Revenue Code and IRAs under section 408(a)(6) and (b)(3) were formerly found in the old 1987 proposed regulations. To calculate minimum required distributions for the 2001 calendar year, taxpayers may use either the new 2001 regulations or the old 1987 regulations.

2. **Question —** Where can I find the new 2001 regulations?

   **Answer —** The new 2001 regulations can be found on page 865 of Bulletin No. 2001-11 (March 12, 2001). For further explanation of the new 2001 regulations, also see Announcement 2001-23, 2001-10 I.R.B. 791, published on March 5, 2001, which contains supplements to Publication 575, Pension and Annuity Income, and Publication 590, Individual Retirement Arrangements (IRAs).

3. **Question —** May an IRA owner use the new 2001 regulations for calendar year 2001 distributions even if the IRA document contains the rules of the old 1987 regulations?

   **Answer —** Yes. As noted in Q&A-1 above, an IRA owner may, but is not required to, use the new 2001 regulations for calculating required distributions made for calendar years beginning on or after January 1, 2001, irrespective of the language of the IRA document.

4. **Question —** Should an IRA document be amended to reflect the new 2001 regulations?

   **Answer —** No. An IRA document should not be amended in calendar year 2001, even if IRA owners are receiving distributions in accordance with the new 2001 regulations.

5. **Question —** May a qualified retirement plan use the rules in the new 2001 regulations to calculate required minimum distributions made for calendar years beginning on or after January 1, 2001?

   **Answer —** A qualified retirement plan may follow the rules in the 2001 regulations to calculate minimum required distributions made for calendar years beginning on or after January 1, 2001. However, a qualified plan must be amended to add either the model amendment set forth in Announcement 2001-I8. 2001-10 I.R. B. 791 (March 5, 2001) or the model amendment set forth in Announcement 2001-82. 2001-32 I.R.B. 123 (August 6, 2001) no later than the end of its GUST remedial amendment period in order for the plan to make required distributions under the new 2001 regulations during calendar year 2001. The amendment need not be made to the plan for a distribution to be made during 2001 under the new rules as long as the amendment is made no later than the end of its GUST remedial amendment period. Revenue Procedure 20027. 2000-26 I.R.B. 272 extends the GUST remedial amendment period for most plans until the end of the first plan year beginning on or after January 1, 2001.

**Continued on page 4**

**From the IRS, Continued from page 3**

6. **Question —** Could a retired employee or IRA owner, who attained age 70 1/2 in 2000 and who received his calendar year 2000 required distribution in calendar year 2001 (by April 1, 2001), have calculated his 2000 required minimum distribution under the new 2001 regulations?

   **Answer —** No. Taxpayers could not rely on the new 2001 regulations for the calculation of the required minimum distributions for the 2000 calendar year. Therefore, for a calendar year 2000 required distribution, even if received during calendar year 2001, taxpayers can only rely on the old 1987 regulations. Failure to use the old 1987 regulations may have resulted in a distribution smaller than that required, and may result in the imposition of an excise tax.

**The following questions and answers assume that the required distributions are being calculated under the new 2001 regulations and are being made from individual account plans.**

7. **Question —** What are the rules for calculating lifetime minimum required distributions under the new 2001 regulations?

   **Answer —** All taxpayers with account balances in either defined contribution plans or individual retirement accounts (IRAs) may calculate their lifetime distributions by using the Table for Determining Applicable Divisor for Minimum Distribution Incidental Benefits (MDIB TABLE) found on page 80 of Publication 590 (Individual Retirement Arrangements). An individual must divide the applicable account balance (which for an IRA is generally the IRAs account balance as of the last day of the calendar year immediately preceding the calendar year for which the required distribution is being made) by the "applicable divisor" listed next to the employee's or IRA owner's age as of the birthday during the year for which the required distribution is being made.

   **Example:** Taxpayer A owns an IRA. On Taxpayer A's birthday in 2001, Taxpayer A reached age 77. As of the end of 2000, the value of Taxpayer A's IRA is $201,000. Taxpayer A looks at the MDIB Table and determines that the "applicable divisor" for a 77-year-old individual is 20.1. Taxpayer A divides $201,000 by 20.1 and determines that the calendar year 2001 required minimum distribution is $10,000, which must be distributed to Taxpayer A no later than December 31, 2001.

8. **Question —** Is there any alternative method of computing lifetime minimum required distributions for matured individuals?

   **Answer —** Yes. If the sole designated beneficiary of a married employee or IRA owner is a spouse who is more than 10 years younger (using their attained ages as of their birthdays during the distribution calendar year), lifetime required distributions are computed by dividing the applicable account balance by the joint life and last survivor expectancy table (Table II beginning on page 76 of Publication 590). Use of Table II produces a smaller amount as a required minimum distribution than use of the MDIB Table.

   **Example:** Individual A, who owns an IRA, is married to Individual B who is Individual A's sole designated beneficiary. Individual A will be 75 on A's birthday in 2001 and Individual B will be 55 on B's birthday in 2001. At the end of calendar year 2000, Individual A's IRA had a value of $293,000. individual A consults Table II and determines that the applicable divisor for a 75 year old with a 55-year-old spouse is 29.3. Individual A divides $293,000 by 29.3 and determines that the calendar year 2001 required minimum distribution is $10,000, which must be distributed to Individual A no later than December 31, 2001. If Individual A has used the MDIB Table, the divisor would have been 21.8 and the required minimum distribution would have been $13,440.37.

9. **Question —** If an employee or IRA owner has reached his or her required beginning date, and has begun to receive distributions under the rules provided in the old 1987 regulations prior to calendar year 2001, may required distributions for calendar years beginning with 2001 be calculated under the new 2001 regulations?

   **Answer —** Yes. For an example, see Q&A-7 above.

10. **Question —** Once required distributions to a 5-percent owner begin on April 1 of the calendar year following the calendar year in which the employee attains age 70 1/2, can required distributions stop if the employee ceases to own more than 5-percent of the employer prior to the employee's retirement?
    **Answer —** No.

11. **Question —** How is the minimum required distribution calculated in the year of death for an employee or an IRA owner?

    **Answer —** If an employee or an IRA owner dies on or after the required beginning date, the required

**Continued on page 5**

THE Pension Digest

**From the IRS,**
**Continued from page 4**

distribution for the year of death is calculated by using either (1) the MDIB Table discussed in Q&A-7, or (2) if the alternative method described in Q&A-8 is applicable, the joint life and last survivor expectancy table mentioned in Q&A-8. If the MDIB Table is used, the applicable account balance is divided by the divisor found in the MDIB Table listed next to the employee's or IRA owner's age as of the birthday in the year of death. If the joint life and last survivor expectancy table is used, the applicable account balance is divided by the divisor listed next to the ages of the employee or IRA owner and the spouse as of their birthdays in the year of death. See Q&As-13 through 15 for the rules on how to calculate the required distributions in years after the year of death.

If an employee or an IRA owner dies before the required beginning date, there is no required distribution for the year of death.

12. **Question —** May a surviving spouse elect to treat the entire IRA of a decedent as the surviving spouse's own?

    **Answer —** After the required distribution for the year of death (if any) is distributed, the surviving spouse is entitled to treat the entire IRA of a decedent as the surviving spouse's own if the surviving spouse is the sole beneficiary of the IRA and has an unlimited right to withdraw the assets from the IRA. This requirement is not satisfied if a trust is named as beneficiary of the IRA even if the spouse is the sole beneficiary of the trust.

13. **Question —** How are post-death minimum required distributions calculated in years after the year of death if an employee or an IRA owner dies without a designated beneficiary?

    **Answer —** If the employee or IRA owner dies prior to his or her required beginning date without a designated beneficiary who is an individual, distribution of the entire account balance must be made no later than December 31 of the fifth calendar year which follows the calendar year of his/her death. If the decedent dies without a designated beneficiary who is an individual on or after the required beginning date, the appropriate account balance is divided by the distribution period which is the divisor listed next to the deceased's age (as of his or her birthday in the year of death) in the single life expectancy table (Table I found on page 75 of Publication 590) reduced by one for each year that has elapsed since the year of death. For special rules if a trust is named as a beneficiary, see Q&As-5 and 6 of section 1.401(a)(9)-4 of the new 2001 regulations.

14. **Question —** What are the rules for calculating post-death required distributions in years after the year of death if a retired employee or IRA owner dies and has a designated beneficiary who is an individual but is not the employee's or IRA owner's spouse?

    **Answer —** Required distributions must be computed by dividing the appropriate account balance by the divisor listed next to the beneficiary's age (as of the beneficiary's birthday in the calendar year following the calendar year of death of the participant or IRA owner) found using Table I at page 75 of Publication 590 reduced by one for each calendar year that has elapsed since the calendar year following the calendar year of death. Distributions to a non-spouse beneficiary must begin no later than December 31 of the calendar year following the calendar year of the employee's or IRA owner's death. See Q&A-7 of section 1.401(a)(9)-5 of the new 2001 regulations for special rules when multiple beneficiaries exist.

15. **Question —** What are the rules for calculating post-death distributions in years after the year of death if an employee or IRA owner dies either prior to or after attaining age 70 1/2 and the employee's or IRA owner's spouse is the sole designated beneficiary?

    **Answer —** The appropriate account balance is divided by the distribution period, which is the divisor listed next to the spouse's age (as of the birthday in the year of distribution) in Table I on page 75 or Publication 590. If an employee or IRA owner dies prior to the year in which the employee or IRA owner would have attained age 70 1/2, distributions to the spouse need not begin until the year in which the employee or IRA owner would have attained age 70 1/2.

16. **Question —** With respect to post-death distributions, when is the determination made as to who is a designated beneficiary?

    **Answer —** December 31 of the calendar year following the calendar year of the employee's or IRA owner's death.

    **Example:** Taxpayer A dies during calendar year 2000 at age 62. Taxpayer A designated Taxpayers B and C, his children, as the beneficiaries of Taxpayer A's IRA. Taxpayers B and C remain the beneficiaries as of December 31, 2001. Taxpayer B and Taxpayer C will be

**Continued on page 6**

**From the IRS,**
**Continued from page 5**

considered designated beneficiaries of Taxpayer A's IRA as of December 31, 2001.

17. **Question —** If an employee or IRA owner died before 2001, can minimum required distributions be calculated under the new 2001 regulations for years beginning with 2001?

    **Answer —** Yes.

18. **Question —** May an employee who receives a distribution from a qualified retirement plan roll over into an IRA the difference between a required distribution that is calculated under the old 1987 regulations and a required distribution that is calculated under the new 2001 regulations?

    **Answer —** Yes, as long as the amount otherwise meets the definition of "eligible rollover distribution" found in Code section 402(c)(4) and section 1.402(c)(2) of the income Tax Regulations, Question and Answer 3.

    **Example:** During calendar year 2001, Employee A elects to receive a single sum distribution in the amount of $100,000 from a qualified retirement plan which distribution does not consist of any after-tax employee contributions. A's 2001 required distribution computed under the 1987 regulations is $10,000. After A receives the required section 402(f) notice advising A of the direct rollover option, at A's election, $90,000 is paid in a direct rollover to an IRA in A's name and $10,000 is paid directly to A. A's required distribution computed using the new 2001 proposed regulations is $7,500. A may roll over an additional $2,500 into an IRA as long as the rollover occurs within 60 days of the date on which A received the $10,000 payment.

19. **Question —** Must a plan withhold tax on, offer a direct rollover option for, and provide the recipient with the explanation described in Code section 402(f), with respect to the additional eligible rollover amount ($2,500) in Q&A-18?

    **Answer —** No.

20. **Question —** Which model amendment should a qualified retirement plan adopt if it begins to make required minimum distributions for calendar year 2001 to some employees under the old 1987 regulations prior to the date on which the plan begins operating in accordance with the new 2001 regulations?

    **Answer —** The plan should adopt the model amendment provided in Announcement 2001-82.

21. **Question —** Must a plan administrator that timely adopts the model amendment provided in Announcement 2001-82 take any corrective action with respect to the portion of any distribution referenced in Q&A-20 that is calculated under the old 1987 regulations and that is in excess of the required minimum distribution calculated using the new 2001 regulations?

    **Answer —** If the entire required minimum distribution for an employee is made before the time when the plan began to operate under the new 2001 regulations for 2001 distributions, the plan sponsor need not take any corrective action.

    If the entire 2001 required distribution was not made prior to the date that the plan begins to operate in accordance with the new 2001 proposed regulations, adjustments in the amount of required distributions for 2001 must be made after the date the plan begins to operate in accordance with the new 2001 proposed regulations.

    **Example:** An employee has a required distribution for calendar year 2001 calculated under the 1987 regulations of $10,000. The employee elects a single sum distribution of $100,000 on May 31, 2001 and, as in Q&A-18, elects a direct rollover of $90,000 to an IRA in the employee's name. The plan sponsor adopts the model amendment found in Announcement 2001-82 within its GUST remedial amendment period. The plan begins to operate in accordance with the new 2001 proposed regulations effective July 1, 2001. Under the new 2001 regulations, the employee's 2001 required minimum distribution is $8,000. The plan administrator need take no corrective action with respect to the $2,000 difference received by the employee.

    **Example:** Another employee has a required distribution for calendar year 2001 calculated under the old 1987 proposed regulations in the amount of $12,000. Pursuant to plan terms, the employee's required distribution is being paid $1,000 per month during 2001. As of June 30, 2001, the employee has received $6,000 in plan distributions. The plan sponsor adopts the model amendment found in Announcement 2001-82 within its GUST Remedial amendment period. The plan begins to operate in accordance with the new 2001 proposed regulations effective July 1, 2001. Under the new 2001 regulations, the employee's 2001 required minimum distribution is $9,000. The plan must distribute $3,000 as a required minimum distribution for 2001, and not $6,000, to the employee during the remainder of 2001.

**Continued on page 7**

THE Pension Digest

**From the IRS,
Continued from page 6**

## *CWF's COMMENTS*

Even though these new RMD rules are not yet finalized, this Question and Answer and the 2001 IRS Publication 590 gives every indication that the rules will be adopted as proposed. The IRS first issued these regulations in Internal Revenue Bulletin 2001-11 on March 12, 2001, indicating that for further explanation of these rules an individual could see IRS Announcement 2001-23, and IRS Publications 575 and 590. Now the IRS has issued this Q&A for further explanation of the new RMD rules.

***Please take note of the following:***

- This Q&A makes very clear that these RMD rules apply beginning 1/1/2001, and that the rules also apply to 2002.
- Q&A 17 makes it clear that if an IRA owner died prior to 2001, say in 1995, the new rules may be used to calculate the 2001 distribution or the 2002 distribution. Although this Q&A does not discuss whether the previous election can be changed (the five-year or life-distribution election), it does state the new rules can be used for the 2001 calculation. We expect the IRS will rule that it will not be possible to change a previous election.
- The IRS has clarified one situation which has been bothersome. People have wondered and asked, "Is there an RMD which must be distributed to the surviving spouse if the accountholder died during the year he or she attained or would have attained age 70 1/2"? Since no one wants to pay a 50% excise tax, many people chose to take a distribution. The IRS, in Q&A 11, makes clear that such a distribution is unnecessary. The IRS states very clearly "If an employee or an IRA owner dies before the required beginning date, there is no required distribution for the year of death."

**Example:** An individual attains age 70 1/2 on 1/2/02, and dies on 3/31/03. Will an RMD be required for 2002 and 2003? The answer is, "No." Because the accountholder turned age 70 1/2 on 1/2/02, he/she would not be required to take the first minimum distribution until 4/1/03. Because the accountholder died prior to his/her required beginning date, then, as stated in Q&A 11, no RMD is required for the year of death, and there would be no RMD requirement for either 2002 or 2003.

How will this person's spouse be affected? The spouse cannot treat the deceased spouse's IRA as their own until the RMD for the year (if any) is distributed. Because no RMD is required from the deceased spouse's IRA in this situation, the surviving spouse can treat the IRA as their own immediately, even if they are age 70 1/2 or older. Will it affect the RMD for the spouse for that year? No, because the money will not be considered to be in the IRA of the surviving spouse and there will be no RMD required for that account for 2002 or 2003.

- In the original Announcement, the IRS called the new table to be used the "uniform table." It now appears that they are again calling it the MDIB Table (Minimum Distribution Incidental Benefits Table).
- This Q&A also makes clear that the new rules cannot be used to calculate the 2000 RMD for persons who waited until the following year to take their distribution.

# IRS Reiterates Position of Denying Rollover When Rollover not Completed Prior to Death

In recent private letter ruling 200204038 the IRS was posed with the following situation and question. An individual was a participant in a pension plan. The participant completed an instruction to the QP plan administrator to directly roll over his vested account balance to an IRA which he had established. The beneficiary of his QP was his son. His son was also the beneficiary of his IRA. However, the participant died before the plan administrator sent the funds to the IRA. The funds were still sent, after his death, to the IRA.

Approximately 15 years ago, the IRS was asked to consider a somewhat similar situation. A QP participant received a distribution from the QP, and during the 60-day rollover period, he died. The representative of the decedent's estate argued that he should be able to complete the rollover as there is a provision in the Internal Revenue Code which allows the personal representative to do what the decedent could have done. The IRS argued that rolling over a distribution is a personal right which lapses upon death. In this one case, the tax court agreed with the personal representative. The IRS never acquiesced with the tax court's decision.

This situation is a little different. This situation arises under the rules which now allow a participant to have a direct rollover. The law mandates that the person is eligible to have a direct rollover, but the law does not define when a direct rollover is accomplished or completed. Is it completed when the participant furnishes the written instruction or is it completed only when the IRA custodian has deposited the funds into the IRA?

With respect to the private letter ruling, the IRS' analysis was that the direct rollover was not completed as contemplated by the law. The IRS went back to their old analysis that a rollover must be completed while the recipient is alive. The IRS acknowledged that neither Code section 402(c) or 401(a)(31), or the regulations thereunder, state this requirement. Since the funds did not meet the

**Continued on page 8**

**IRS Position,**
**Continued from page 7**

rollover requirement and since the beneficiary was a nonspouse beneficiary who himself was not eligible to roll over a distribution from a qualified plan, the beneficiary will be required to withdraw the contribution from the IRA as an excess contribution and include it in his income.

Similar situations will arise. For example, you have a customer who comes in to your financial institution and establishes an IRA. You and your customer complete the direct rollover instruction form which the employer had given him. He furnishes it to his employer. He then dies before you are sent the funds or assets. Will you, as the IRA custodian, allow the rollover to be completed or not? Will the QP beneficiary designation or the IRA beneficiary designation control the disposition of the assets?

Conclusion. The law is unsettled. You will wish to act on the advice of your legal counsel. One should remember that the IRS is not always right in their administrative positions. The IRS generally adopts a stance which will increase tax revenues.

# Reminder – Like it or Not, Tax Law Changes Can Generally be Made Retroactively

When the Roth IRA laws were first enacted, they did not provide a recapture tax for the following situation. A person who had not yet attained age 59 1/2 could convert his traditional IRA to a Roth IRA. He did not owe the 10% additional tax, because the 10% tax is not owed when one converts funds from a traditional IRA to a Roth IRA. Once the funds were in the Roth IRA, the individual was free to withdraw the converted funds from the Roth IRA without owing the 10% additional tax since that tax is owing only if the distribution is included income. The distribution from the Roth IRA was not included income because it was a return of his basis (i.e. the amount he had converted). Congress felt they had to close this loophole, as too many pre-age 59 1/2 tax taxpayers would use this short-term conversion method to avoid the 10% additional tax.

Congress and President Clinton chose to end this “too good to be true” tax result by imposing a special recapture tax. A person who converted funds from his traditional IRA to a Roth IRA and then took a distribution within a five-year period will owe a special 10% additional tax. Even though this law change was not made until July of 1998, it was retroactively effective as of January 1, 1998.

There were taxpayers who withdrew from their Roth IRAs the amount they had converted within the first six months of 1998. They thought they would not owe the 10% additional tax.

One such taxpayer was Mr. Kitt. He had converted his traditional IRA to a Roth IRA early in 1998. He had immediately taken a distribution from his Roth IRA to make mortgage payments. He was only age 44. He did not pay the additional 10% tax.

He did not feel it was fair that a retroactive tax law had been passed. He felt he had the right to rely on this law change. Therefore, he and his wife argued in the Court of Federal of Claims that the retroactive imposition of this recapture tax was not only unfair, it was unconstitutional. It violated either the Due Process Clause of the Fifth Amendment, the Takings Clause of the Fifth Amendment, or Excessive Fines Clause of the Eighth Amendment.

The U.S. Court of Appeals for the Federal Circuit recently ruled against Mr. Kitt in Kitt vs United States (CA-FC). His due process was not violated and there was no impermissible taking, because the retroactive aspect of the law change was rationally related to the legitimate governmental purpose of disallowing tax benefits which were never intended to be given to the taxpayers. Congress is permitted to correct a mistake. There also was not a violation of the Excessive Fines Clause which generally will be found only when the individual is being punished. In this case, the court said that imposing a tax is not a punishment.

The court was well aware that there are constitutional limits as to “how” retroactive a tax law change may be. However, there was no such problem, because this law change was made relatively soon after such law had first gone into effect.

**SIMPLE-IRA Plans,**
**Continued from page 1**

as the employer made a 3% matching contribution; and there was no requirement to file the Form 5500. Because of the lower administrative costs, many smaller employers in recent years have terminated their 401(k) plans and established a SIMPLE-IRA plan. Many such employers and the employees are surprised to learn that they are not able to combine their 401(k) funds with their SIMPLE-IRA funds. There will be substantial tax problems if such rollovers are made when they are not authorized.

For whatever reason, the only type of funds which can be rolled over into a SIMPLE-IRA plan are funds which arise from another SIMPLE-IRA plan. Funds in any other type of plan or IRA are INELIGIBLE to be rolled over into the SIMPLE-IRA.

Funds in a SIMPLE-IRA may be rolled over or transferred to another SIMPLE-IRA plan or to a traditional IRA after a two-year requirement has been satisfied. They cannot be rolled over into the other types of employer plans – 401(a), 403(b) or 457(b).

Congress should move to allow rollovers into and out of SIMPLE-IRAs as has been done for the other types of employer-sponsored plans. We will see how long it takes Congress to make this change.