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The Pension Digest

Also in this issue –

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

Inheriting a Parent's IRA

Recently, many of you have called us to ask what needs to be done when an IRA accountholder dies on or after his or her required beginning date and the RMD for 2003 has not been totally distributed to the accountholder.

The answer is: the RMD amount for 2003 will need to be paid to the beneficiary or beneficiaries by December 31, 2003, and then the RMD amount for subsequent years will need to be distributed to the beneficiary(ies) by December 31 of each year. The beneficiary may always take a distribution amount greater than the RMD amount, unless, for some reason, the IRA accountholder had imposed a special restriction. Such a restriction will normally only occur with respect to "trust" IRAs and not standard "retail" IRAs.

The following situation illustrates the application of the RMD rules. Rosi Read was born on 4-10-29. She died on 9-20-03. She had designated her two daughters, Imelda and Anita, as her two primary beneficiaries. Each was to receive 50% of the IRA as of Rosi's death. Rosi's RMD amount for 2003 was $1,900. It had already been determined by dividing her IRA's 12-31-02 balance of $45,220 by 23.8 (from the Uniform Lifetime Table). No amount had been paid to Rosi in 2003. Imelda was born on 4-24-52. Anita was born on 7-8-55. Your institution will establish two separate inherited IRAs for Imelda and Anita by 10-31-03.

The RMD amount for 2003 must be distributed to the beneficiaries by December 31, 2003. Imelda and Anita will each be required to be paid $950 (50% share) by December 31, 2003.

The RMD amount for 2004 for Imelda will be calculated by using the standard formula – IRA balance as of 12-31-03, divided by the factor from single life table. She is age 52 in 2004. The factor from the single table is 32.3. The factors for 2005 and other subsequent years will be determined by using the "reduce by one" method:

2005: 31.3 (32.3 - 1.0)
2006: 30.3 (32.3 - 2.0)
2007: 29.3 (32.3 - 3.0)
2008: 28.3 (32.3 - 4.0)
Continues

The RMD amount for 2004 for Anita will be calculated by using the standard formula – IRA balance as of 12-31-03, divided by the factor from single life table. She is age 48 in 2004. The factor from the single table is 36.0. The factors for 2005 and other subsequent years will be determined by using the "reduce by one" method:

2005: 35.0 (36.0 - 1.0)
2006: 34.0 (36.0 - 2.0)
2007: 33.0 (36.0 - 3.0)
2008: 32.0 (36.0 - 2.0)

The above illustration discusses the rules which apply when an IRA accountholder died on or after his or her required beginning date. The RMD rules are similar, yet somewhat different when the IRA accountholder dies before his or her required beginning date. The difference is: a beneficiary has the right to elect to comply with the RMD rules by using the five- (5) year rule rather than the life-distribution rule. Remember, the 2002 IRS model form provides that a beneficiary is deemed to have elected the life-distribution rule unless he or she expressly elects the five-year rule. Taking a lump-sum distribution certainly complies with the five-year rule and the life-distribution rule.

Reminder

December 31, 2003, is the deadline for those inheriting beneficiaries using the five-year rule to elect to switch to the life-distribution rule. The five-year rule applies only when the IRA owner dies before his or her required beginning date.

Illustrating When a Surviving Spouse Most Likely Does Not Want to Treat the Deceased Spouse's IRA as His or Her Own IRA

A surviving spouse will generally elect to treat the deceased spouse's IRA as his or her own IRA. But "generally" is not "always." When a spouse elects to treat the deceased spouse's IRA as his or her own, then the funds within that IRA are treated as if they had originally been contributed by the surviving spouse. The standard IRA rules apply—additional contributions may be made, and distributions will not be mandatory until the surviving spouse is age 70½ or older, because the IRA is no longer an inherited IRA.

The following situations illustrate when a surviving spouse most likely does not want to treat their deceased spouse's IRA as their own. However, read "The Earlier, the Better" article describing the risk assumed when a surviving spouse does not immediately elect to treat his or her deceased spouse's IRA as his or her own IRA.

Situation #1. Tom Moe is age 57 (4-10-56). His wife, Sara Moe is age 56 (5-30-57). Tom dies in 2003. Tom has an IRA, but Sara does not. If Sara might need to use some of the IRA funds in the inherited IRA before she attains age 59½, then she will not want to treat Tom's IRA as her own IRA. As long as the IRA is an inherited IRA, any distributions made to Maria will not be subject to the 10% additional tax. Since Tom is only age 57, Sara is not required to commence distribution under the life-distribution rule until the year Tom would have attained age 70½. This would be 12-31-2016. Sara will attain age 59½ on 11-30-2006. The final RMD regulation provides a spouse beneficiary the right to treat a deceased spouse's IRA as his own at any time. She might as well do so when she attains age 59½. While the IRA remains an inherited IRA, she has the right to designate her own beneficiary(ies) so she is not worse off in that sense.

Situation#2. William Roe is age 65 (2-10-38). His wife, Donna Roe, is age 72 (5-30-31). William has an IRA, but Donna does not. William dies in 2003. In this situation, Donna may not want to treat William's IRA as her own because she is subject to the RMD rules, and he was not. By not treating his IRA as her own, she can delay her first required distribution with respect to the inherited IRA funds until 12-31-2007.

Situation #3. John Doe is age 55 (2-10-48). His wife, Maria Doe is age 50 (5-30-53). John dies in 2003. John has an IRA, but Maria does not. If Maria might have a need to use some of the IRA funds in the inherited IRA before she attains age 59½, then she will not want to treat John's IRA as her own IRA. As long as the IRA is an inherited IRA, any distributions made to Maria will not be subject to the 10% additional tax. Since John is only age 55, Maria is not required to commence distribution under the life-distribution rule until the year John would have attained age 70½. This would be 12-31-2018. Maria will attain age 59½ on 11-30-2012. The RMD regulation provides that a spouse beneficiary has the right to treat a deceased spouse's IRA as his own at any time. This means she has the authority to elect to treat his IRA as her own on or after such date. While the IRA remains an inherited IRA, she has the right to designate her own beneficiary(ies) but as discussed below, there are limits to this benefit.

Situation #4. Bill Foe is age 68 (2-10-35). His wife, Barb Foe is age 58 (5-30-45). Barb dies in 2003. Bill has an IRA and so does Barb. Bill will be 70½ in 2005. If he elects to use the life-distribution rule, he is not required to take his first required minimum distribution until 12-31-15. Thus, he is allowed to defer distributions for an additional 10 years.

The above situations illustrate that a surviving spouse beneficiary may not, in some situations, want to treat their deceased spouse's IRA as his or her own. Such spouses should definitely act on the advice of their tax/legal advisor.

The Earlier, the Better

Many husbands and wives have IRAs. One for the husband, and one for the wife. Many such accountholders are now over age 70½. The purpose of this article is to illustrate that it is generally desirable for a surviving spouse to elect to treat his/her deceased spouse's IRA as his/her own as early as possible after the death of the first spouse, so that the beneficiaries will be able to use the longest possible distribution period. Failure to make this election by a surviving spouse can mean there will be a much shorter distribution period for children or grandchildren than would otherwise have been the case.

Example: John Morgan was born March 13, 1928. He is age 75. His IRA balance as of 12/31/02 was $69,000. His required distribution for 2003 is $3,013.10 ($69,000/22.9). Louise Morgan was born on September 15, 1931. She is age 72. Her IRA balance as of 12/31/02 was $78,000. Her required distribution for 2003 is $3,046.88 ($78,000/25.6). John and Louise are married. John dies on October 6, 2003. Neither John nor Louise had been paid their required minimum distribution prior to John's death. What rules and options apply to this situation?

Rule #1. The RMD amount of $3,013.10, which had already been calculated for John, will need to be paid to Louise on or before December 31, 2003. The rules do not permit John's final RMD amount to be paid to John or to his estate. It is to be paid to the beneficiary, which, in this case, is Louise. This is true regardless of whether or not Louise elects to treat the IRA as her own.

Rule #2. The RMD amount of $3046.88 which had already been calculated for Louise, will need to be paid to her on or before December 31, 2003.

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Rule #3. Louise has the option of treating John's IRA as her own. She may either add it to her existing IRA, or she may set up a second IRA for herself as the IRA accountholder. It is assumed that she designated her daughter, Helen, who was born on 10/10/55, as the beneficiary of her IRA or IRAs. Louise's RMD amount for 2004 will be determined by using the Uniform Lifetime Table and her age of 73. Her distribution period will be 24.7. It is assumed the balance of this IRA would be $72,000 as of 12/31/03. Therefore, her 2003 RMD will be $2,914.98.

Rule #4. Louis has the option of maintaining this IRA as an inherited IRA (e.g. "Louise Morgan as beneficiary of John Morgan's IRA"). She, as any beneficiary, is required to take a required distribution each and every year commencing with 2004 (i.e. the year after the year of the death) from the inherited IRA. It is assumed the balance of this IRA would be $72,000 as of 12/31/03. Therefore, her 2004 RMD for this inherited IRA will be $4,864.86, determined as follows; $72,000/14.8. Note that the distribution period is based on Louise's age of 73 in 2004. It is assumed that she designated her daughter, Helen, who was born on 10/10/55 as the beneficiary of this inherited IRA.

It is now assumed that Louise elected to treat John's IRA as her own in December of 2003. It is also assumed that Louise dies on 5/5/04.

What distribution period will apply to 2004? It will be 24.7 if Louise had treated John's IRA as her own IRA, and it will be 14.8 if she maintained the IRA as an inherited IRA. In general, the RMD amount will be 41% higher under the inherited IRA approach.

What distribution period will apply to 2005? It will be 34.2 if Louise had treated John's IRA as her own IRA, and it will be 13.8 if she maintained the IRA as an inherited IRA. The following chart compares the RMD payout period and amounts. It is assumed the IRA had a beginning balance of $72,000, and the earnings rate will average 5% per year.

Elect as Own

Year	Beginning Account Balance	Earnings at 5%	Distribution Period	RMD	Ending Account Balance
2004	$72,000	$3,600	24.7	$2,915	$72,685
2005	72,685	3,634	34.2	2,125	74,194
2006	74,194	3,710	33.2	2,235	75,669
2007	75,669	3,783	32.2	2,350	77,102
2008	77,102	3,855	31.2	2,471	78,486
2009	78,486	3,924	30.2	2,599	79,812
2010	79,812	3,991	29.2	2,733	8,1069
2011	81,069	4,053	28.2	2,875	82,248
2012	82,248	4,112	27.2	3,024	83,336
2013	83,336	4,167	26.2	3,181	84,322
2014	84,322	4,216	25.2	3,346	85,192
2015	85,192	4,260	24.2	3,520	85,932
2016	85,932	4,297	23.2	3,704	86,524
2017	86,524	4,326	22.2	3,897	86,953
2018	86,953	4,348	21.2	4,102	87,199
2019	87,199	4,360	20.2	4,317	87,242
2020	87,242	4,362	19.2	4,544	87,060
2021	87,060	4,353	18.2	4,784	86,630
2022	86,630	4,331	17.2	5,037	85,925
2023	85,925	4,296	16.2	5,304	84,917
2024	84,917	4,246	15.2	5,587	83,576
2025	83,576	4,179	14.2	5,886	81,869
2026	81,869	4,093	13.2	6,202	79,761
2027	79,761	3,988	12.2	6,538	77,211
2028	77,211	3,861	11.2	6,894	74,178
2029	74,178	3,709	10.2	7,272	70,614
2030	70,614	3,531	9.2	7,675	66,469
2031	66,469	3,323	8.2	8,106	61,687
2032	61,687	3,084	7.2	8,568	56,204
2033	56,204	2,810	6.2	9,065	49,949
2034	49,949	2,497	5.2	9,606	42,841
2035	42,841	2,142	4.2	10,200	34,782
2036	34,782	1,739	3.2	10,870	25,652
2037	25,652	1,283	2.2	11,660	15,275
2038	15,275	764	1.2	12,729	3,310
2039	3,310	165	0.2	3,475	0
	Total	**$127,394**		**$199,394**	

Inherited IRA

Year	Beginning Account Balance	Earnings at 5%	Distribution Period	RMD	Ending Account Balance
2004	$72,000	$3,600	14.8	$4,865	$70,735
2005	70,735	3,537	13.8	5,126	69,146
2006	69,146	3,457	12.8	5,402	67,201
2007	67,201	3,360	11.8	5,695	64,866
2008	64,866	3,243	10.8	6,006	62,104
2009	62,104	3,105	9.8	6,337	58,872
2010	58,872	2,944	8.8	6,690	55,125
2011	55,125	2,756	7.8	7,067	50,814
2012	50,814	2,541	6.8	7,473	45,882
2013	45,882	2,294	5.8	7,911	40,266
2014	40,266	2,013	4.8	8,389	33,890
2015	33,890	1,695	3.8	8,918	26,666
2017	26,666	1,333	2.8	9,524	18,476
2018	9,135	457	0.8	9,592	0
	Total	**$37,259**		**$109,259**	

Conclusion. A surviving spouse, by electing to treat a deceased spouse's IRA as his or her own, can give a child or grandchild a much longer distribution period. Two tax benefits may be realized. First, the required distribution amount to the spouse will be smaller. Secondly, the longer payout period for the next beneficiary means the funds stay within the IRA longer, and thus the taxation of the earnings (and the payment of taxes on such distributions) are deferred for that longer period. In the case of the example, for an additional 21 years. An additional $90,135 will be accumulated and distributed from the "elected as own" IRA versus the inherited IRA.

IRA & Qualified Domestic Trusts

IRA grantors many times designate a trust as their IRA beneficiary. There are many types of trusts. One of those trust types is a qualified domestic trust (QDT). Should a QDT be designated as a person's IRA beneficiary? As will be discussed, the general rule is that they should not be. There must be required distributions from the inherited IRA to the trust beneficiary. At some point in time, the required distribution amount will be sufficiently large so that more than just income will be distributed from the trust. If this happens, the additional tax which applies to a QPT will be owing.

Background. One of the standard rules of estate taxation law is that an unlimited deduction is granted for the property which passes from the deceased spouse to the surviving spouse. The effect of the unlimited deduction is to postpone the federal estate tax until the surviving spouse dies. This rule is found in Code section 2056. At one time it was granted to all spouses regardless of whether both were citizens of the U.S.

In 1988, the TAMRA law included a provision which disqualified the marital deduction when the surviving spouse was not a U.S. citizen. The purpose of the law change was that it was thought the estate tax was not being collected as often as it should have been when the inheriting surviving spouse was living outside of the U.S. In fact, prior to TAMRA, a surviving spouse who had been living in the U.S., many times gave up his or her U.S. residence and returned to his or her home country. If an estate is not able to use the marital deduction to lower the taxable estate, then it will have to pay more estate taxes than a similar estate which uses the marital deduction.

TAMRA defined and created the requirements to have a QDT. The concept being—as long as the government can be reasonably assured of collecting the estate tax after the second spouse dies, the estate of the first spouse will be able to claim the marital deduction, and the estate of the non-citizen surviving spouse will include the fair market value of the subject property.

To quality as a QDT, a trust must meet the following requirements:

1. At least one trustee must be a U.S. citizen or a U.S. corporation. The proposed regulation provides that one of the trustees must be a corporate trustee if the value of the trust assets will exceed $2 million, unless the trustee furnishes a bond equal to 65% of the fair market value of the trust corpus. The regulations also require that the trust assets be held in the U.S.

2. A QDT election must be made by the executor on the decedent's estate tax return within one year after the due date of the tax return (including extensions). Once it is made, it is irrevocable.

3. Corpus is not eligible to be distributed unless the trustee has the legal right to withhold estate tax imposed on the trust whenever there is a distribution. Each trustee is personally liable for the tax owing.

4. Regulations have been written to ensure collection of the tax owing. The regulations require the trustee to hold sufficient U.S. assets to pay the state tax or post a bond.

The estate tax laws provide for an additional tax if a "taxable event" occurs after the first spouse has died and there is a QDT. If a taxable event occurs, the estate tax owed is determined as if it had been included in the first spouse's estate. The tax rate to be applied to the distribution will be the marginal rate applicable to the first estate as adjusted by this distribution. The taxable events are:

1. The trust fails to remain a QDT because it fails to remain qualified for any reason. One reason would be if the surviving spouse became a U.S. citizen.

2. The general rule is that any distribution from the QDT prior to the death of the non-citizen surviving spouse results in the trust becoming taxable. There are two exceptions, however. There is not a taxable event if a distribution of income is made to the non-citizen surviving spouse as ordinary income and it will be subject to withholding at the 30% rate, unless a treaty would authorize a lower rate. The second exception is a "hardship" exception. It is very surprising, but the proposed regulation does not define hardship. Most likely a hardship will occur in certain financial and medical situations.

3. The death of the non-citizen surviving spouse. If a taxable event occurs, Form 706-QDT must be filed on or before April 15 of the following year. Extensions may be granted for good cause. However, if the taxable event is the death of the non-citizen's surviving spouse, then it must be prepared within nine (9) months of such death. The trust will be required to file an annual income tax return (Form 1041, U.S. Fiduciary Income Tax Return) for each year the QDT is in existence. The due date is the 15th day of the fourth month following the trust's year end.

Summary. In general, a QDT should not be designated as the beneficiary of a person's IRA, because the required distribution rules could lead to the imposition of the tax which applies when there is a taxable event. However, in some situations there may be no other alternative. Some surviving spouses do not want to become U.S. citizens, or they are not able to become citizens before the filing of the first to die spouse's estate tax return.

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Depository Only for SEP Funds – Responsible for Updating the SEP Plan?

An employer who establishes a Simplified Employee Pension plan (SEP plan) must establish its plan by completing a prototype document such as CWF's SEP prototype, or by completing the IRS Model Form 5305-SEP. The employer wishing to establish a SEP will expect a financial institution to have the applicable documents available.

When a SEP IRA is established, an institution will need to know whether it is dealing with the employer, or with an employee whose employer has established a SEP plan at a different institution. An institution may encounter a situation where an employee has established a SEP IRA at your institution, but the employer's SEP document was established at another institution. The employer is required to furnish a copy of its SEP document to every eligible employee. In order for an institution to treat ANY SEP deposit as made to a SEP IRA, it will need to have a copy of the SEP plan document. Therefore, if an institution is not the one who has established the SEP plan, you will need to ask your customer to provide you with a copy of the employer's SEP plan document.

If an institution does not receive a copy of the SEP plan document, it really has no authority to treat contributions made to the IRA as SEP IRA contributions. Technically, the account should be treated as a normal traditional IRA, and the contribution limits would be greatly reduced compared to the SEP contribution limits. Any amount over the normal $3,000/$3,500 for 2003, should be treated as an excess, in the absence of the authority to treat the deposits as SEP contributions.

If the bank is merely the depository for SEP IRAs of an employer's employees, does this institution have the requirement to update the SEP plan? The answer is, "No." The bank has no duty to update the SEP plan of these employees; it is the employer's duty to furnish these employees with a copy of its updated SEP document.

If an institution finds itself in this situation, CWF suggests that you send a letter to the employers notifying them that you cannot accept their employees' contributions as SEP contributions unless you have a copy of their current document, proving that, indeed, the contributions are made pursuant to a current SEP plan. You may need to remind them that the SEP document needs to be updated in order for the employers to take advantage of the new, higher contribution limits allowed for 2003.

Disabled or Not

The IRS' job is to collect the taxes the U.S. government is owed. The IRS can be very persistent in doing its job; sometimes too persistent. The IRS does not accept every argument requesting a waiver of a tax owing. As is well known, a person under age 59½ will not owe the 10% additional tax imposed by Code section 72(t) if he/she is disabled. Code section 72(m)(7) defines disability as follows:

> (7) Meaning of disabled.—For purposes of this section, an individual shall be considered to be disabled if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration. An individual shall not be considered to be disabled unless he furnishes proof of the existence thereof in such form and manner as the Secretary may require.

In a recent case, the IRS vigorously argued that a taxpayer was not disabled for IRA/pension purposes, but the tax court concluded the taxpayer was sufficiently disabled so she did not owe the 10% tax for her early distribution from a pension plan. The case was Mary L. Coleman–Stephens v. Commissioner of Internal Revenue, U.S. Tax Court, No. 14979-02S, July 17, 2003.

The facts were as follows. A federal employee was a participant in the Federal Employees Thrift Savings Plan (TSP). From 1997-2000, she was being treated for "brief periods" of depression. She was hospitalized for some of this time. Her doctor had initially determined that she could return to work as long as she did not have to perform any supervisory duties. The doctor then concluded that she should not return to work. The doctor had concluded that "progress noted and fair prospects of eventual return to work in some capacity." During this period she had taken a loan from the TSP and defaulted on its repayment. The government had prepared the Form 1099-R and used the reason code "1" for a premature distribution with no known exception. She filed her 1999 tax return and included in her income the amount of the defaulted loan, but she did not pay the 10% additional tax. The IRS sought to collect the 10% tax. The IRS made two arguments as to why she owed the 10% tax. First, the fact that she could not do her old job did not mean she could not perform some substantial gainful activity. Second, her condition was not indefinite, since her doctor had written she had a fair prospect to return to work.

The tax court disagreed with the IRS. It concluded her condition was sufficiently indefinite so that she could not engage in substantial gainful activity.

This case illustrates three lessons. First, the IRS will argue that many individuals who claim to be disabled do not meet the definition as found in Code section 72(m)(5). Second, the taxpayer can still claim the disability exception on Form 5329, even though the preparer of the Form 1099-R used a reason code "1" and not a reason code "3." Third, one can see why accountants argue for the use of a reason code other than "1" in some situations, because it is hard for the taxpayer to convince the IRS, in many situations, that an exception applies, when the reporting entity does not determine that a specific exception applied.

State Law Peculiarities

IRAs are primarily a creature of federal tax law. However, state laws impact IRAs greatly. Who inherits? Can creditors garnish IRAs to satisfy a debt? What happens with an IRA upon a divorce? Those are some of the uncertainties.

We are starting a new section within our newsletter. The purpose of this section will be to highlight a specific state's law on a particular subject. The law may have been created by the state's legislature, by a court's decision interpreting a statute, or by a judge or judges creating law, because there was no specific statute covering the situation in question.

We will be highlighting those laws (or court decisions) which impact IRAs that we believe need to be revised. We will state why we believe there should be a change.

We will start with a court case dealing with Minnesota law. Next month we will consider a case dealing with Michigan law. The following month we will discuss an Iowa situation.

M.S.A. section 550.37 defines the property which is exempt from creditor claims in Minnesota. Subdivision 24 applies to employee benefits. It reads as follows:

> Subd. 24. Employee benefits. (a) The debtor's right to receive present or future payments, or payments received by the debtor, under a stock bonus, pension, profit sharing, annuity, individual retirement account, Roth IRA, individual retirement annuity, simplified employee pension, or similar plan or contract on account of illness, disability, death, age, or length of service, to the extent of the debtor's aggregate interest under all plans and contracts up to a present value of $30,000 and additional amounts under all the plans and contracts to the extent reasonably necessary for the support of the debtor and any spouse or dependent of the debtor.
>
> (b) The exemptions in paragraph (a) do not apply when the debt is owed under a support order as defined in section 518.54, subdivision 4a.

The Minnesota case is in re: Anderson, U.S. Bankruptcy Panel, Eighth Circuit, No. 01-6044, November 5, 2001. The facts were these:

Mr. Anderson filed his bankruptcy petition on 3-21-01. He claimed two exemptions with respect to two IRA accounts. An exemption means he is allowed to retain the asset, and it will not be used to pay creditors. IRA #1 was his own IRA, and he claimed an exemption of $21,317.46. IRA #2 was an IRA which he had acquired from his former wife. He was divorced in October of 2000, and he was awarded $25,000 from her IRA. His portion of the IRA had decreased in value to approximately $19,000 as of 3-21-01. He and his attorney had been slow, and the actual transfer to his IRA had not yet occurred.

The bankruptcy trustee argued that the $19,000 in IRA #2 was not entitled to be exempted from the bankruptcy estate. That is, the trustee argued, this $19,000 should be included in the bankruptcy estate and be distributed to various creditors. Both the bankruptcy court and this appellate panel agreed with the trustee for the following reasoning. We at CWF find this reasoning very weak and incorrect. As indicated below, a bankruptcy court adopted a certain rationale in a case of first impression, and then a number of courts simply adopted this same rationale for later cases. We believe the initial decision was incorrect for reasons discussed below.

In Deretich v. City of St. Francis, 128 F 3d 1209 (8th Cir. 1977) the Eighth Circuit held that "the district court did not err in construing the state statute governing garnishment and attachment to require the assets be directly derived from the debtor's employment in order for the employee benefits exemption to apply." The Deretich decision cited a Minnesota Court of Appeals case, Westinghouse Credit Corp. v. J. Reiter Sales, Inc. which held that "benefits which are exempt under subdivision 24 are those derived from an employment relationship or from self-employment endeavors." Westinghouse, in turn, had relied upon a Minnesota bankruptcy case, in re: Raymond, which had held that, although the statutory heading "Employee benefits" would not be considered part of the statute, that heading, along with other factors, strongly indicated that the Minnesota legislature "intended only to exempt those listed assets which derived from an employment relationship or from self-employment endeavors."

CWF's Observations. The statute exempts a person's right to receive payments (present or future) "UNDER" various pension plans or IRAs. A person can have the right to receive payments for many reasons—he or she was a participant, he or she was a beneficiary of a participant, or he or she was a former spouse and now qualifies as an alternate payee under the plan.

The statute contains no express statement that the assets to be exempt must have derived from the debtors "own" employment or self-employment endeavors. One consequence of such a court-made rule is that a spouse who acquires IRA funds pursuant to a divorce is NOT entitled to exempt such assets in bankruptcy or from other creditors. This is certainly a trap for the unwary.

What about inherited IRA funds? It appears that a similar rule (i.e. no exemption permitted) would apply to IRA and pension funds which have been inherited. Such funds were not acquired from their work and therefore are not entitled to exemption. In summary, we believe the legislature intended to apply exemption treatment to all funds within pension plans and IRAs regardless of who originally performed the work. "Tracing" problems could certainly arise. As a practical matter, Mr. Anderson's problem arose because IRA #2 was listed separately because he and his attorney had not finalized the divorce by transferring the $25,000/$19,000 from her IRA to his own IRA.

Also, note that Minnesota has revised its law by adding subsection (b) so that the exemptions will not apply when the debt is owed pursuant to a support order (e.g. child, alimony, etc.). Most states have adopted a similar law. In a couple months, we will discuss the Iowa exemption statute. Iowa has a very interesting statute.

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Determining Whether a Correction Is Prompt for Purposes of Having the Reporting Penalties Waived by the IRS

The IRS has recently revised the existing regulation governing when the IRS will waive the penalties under Code section 6721. REG-141669-02 was originally set forth in I.R.B. 2003-64 as issued on August 25, 2003. Code section 6721 applies to all reporting forms except Forms 1099-MSA, 1099-R, 5498, 5498-ESA and 5498-MSA. Code section 6721 creates a three-tiered penalty structure to encourage timely filing and prompt correction of errors in previously-filed returns.

The first tier penalty is $50 per failure, to a maximum of $250,000 per calendar year. It is owed when there is a failure to prepare a correct form. The second tier penalty is $15 per failure, to a maximum of $75,000 per year, and applies if the filer corrects a failure within 30 days of the required beginning date. The third tier penalty is $30 per failure, to a maximum of $150,000 per year, and applies if the filer corrects a failure more than 30 days after the required beginning date, but before August 1 of the calendar year during which the required beginning date occurs.

In some situations, a filer may qualify to have the IRS waive the collection of these penalties. Code section 6724 provides a waiver of the penalties if the failure giving rise to such penalties was due to reasonable cause and not willful neglect. The late filer does this by either establishing that there were significant mitigating factors, that the failure arose from an "impeding" event beyond the filer's control, or that it has acted in a reasonable manner in performing its filing duties. One of the factors which the IRS reviews is how promptly the filer takes action to avoid or mitigate the failure. Under the existing regulation, the filing of a "failed" return is considered to be prompt only if it is made within 30 days of the removal of the impediment or the discovery of the failure, or if it is made on the earliest date thereafter on which a regular submission of corrections occurs. Submissions must be made every 30 days in order to meet the second requirement. The existing rules did not allow a filer to efficiently "bundle" the filing of a correct return for their failed returns. A filer was required to submit multiple filings.

The IRS has proposed to amend the regulation to provide that a correction will qualify as being prompt if the filer makes the correction (i) within 30 days of the required filing date, or by August 1 following the required filing date, (ii) by the date or dates announced by the IRS in guidance governing electronic or magnetic filing of information returns (expected to be in November and/or December of the same year), or (iii) within 30 days of the impediment being removed or the failure is discovered, if occurring after the date in (ii).

This new rule will not go into effect until the final regulation is adopted. However, the IRS will allow filers to cite the revised proposed rules in any request to receive a reasonable request waiver prior thereto.

Summary. The IRS has changed the definition of what action is considered "prompt" for purposes of determining whether or not a late filer had reasonable cause for being late. The practical effect of the change is that the IRS is allowing the filer (e.g. the IRA custodian) to submit its corrections to the IRS by August 1 rather than applying the 30-day rule to each failed return. Be aware, though, of what was not revised. The rule for determining whether or not there has been reasonable cause for purposes of waiving the penalties under Code section 6722 (furnishing statements to recipients/payees) and 6723, were not revised. The 30-day correction period still applies for this purpose. In addition, the timing schedule for the tiered penalties was not changed. In the event the IRS does not waive the penalties under Code section 6724, then the only way a filer can be ensured of owing a penalty less than the $50 per failure will be to file the corrected returns within 30 days after the required filing date, or before August 1 of the calendar year in which the required filing date occurs, unless the de minimus rule for corrections would apply. Even though a filer cannot show reasonable cause, the penalty for failure to file correct information returns will not apply to a certain number of returns if a filer:

a. Filed those information returns,

b. Either failed to include all the information required on a return or included incorrect information, and

c. Filed corrections by August 1.

If you meet all the conditions in a, b, and c above, the penalty for filing incorrect returns (but not for filing late) will not apply to the greater of 10 information returns or 1/2 of 1% of the total number of information returns you are required to file for the calendar year.

Too High Interest Rate Means Trouble for Substantially Equal Periodic Payments

A recent tax court case illustrates that the additional 10% tax will be found owing if an IRA accountholder establishes his or her substantially equal periodic payment schedule and uses an unreasonable interest rate. The IRS convinced the tax court that the IRA accountholder had used too high an interest rate in Dennis W. Farley, Jr., et al v. Commissioner of Internal Revenue, U.S. Tax Court, No. 7920-01S.

The tax court looked at the examples the IRS had provided in Notice 89-25 as subsequently modified by Rev. Rul 2002-62. The taxpayer had used an interest rate approximately 20% higher. This was found to be unreasonable. The IRS, therefore, was authorized to assess the additional 10% tax of Code section 72(t).

An interest rate of 8% was used in the two examples set forth in Q/A–12 of Notice 89-25. 20% higher would be 9.6%.

401(k) Elective Deferrals Must Be Timely Deposited to the Plan's Trust

In recent years, the Department of Labor (DOL) has intensified its efforts to enforce the deadline for depositing employee contributions to 401(k) and other qualified retirement plans. For these purposes, employee contributions include elective deferrals, catch-up contributions, after-tax contributions and loan repayments. Before we take a look at some of the actions the DOL has taken in just the last year, we need to have an understanding of the current remittance requirements.

Under DOL regulations, employee contributions become plan assets on the *earlier of:*

(a) The *earliest date* on which the contributions can reasonably be segregated from the employer's general assets; or

(b) The *15th business day* of the month *following the month in which the contribution is withheld by the employer* from the employee's wages. (Note that for SIMPLE Plans, the time limit by statute is 30 days after the end of the month in which the deferral is made.)

There has been significant misunderstanding regarding this deadline, as many employers automatically use the outside deadline (i.e. the 15th business day of the following month). The DOL believes that virtually all employers are able to separate wage-withholding amounts well in advance of the applicable maximum period, and in many cases, only a week following withholding.

An employer that is late in depositing 401(k) contributions may have breached its fiduciary duty and committed a prohibited transaction.

The DOL's Voluntary Fiduciary Correction Program (VFCP) permits an employer to resolve any potential liability for the breach of fiduciary duty. This requires the employer to make a "lost earnings" contribution to the plan. The contribution is intended to restore to the plan the earnings the contributions would have made if they had been deposited on time. To correct the prohibited transaction, the employer may file Form 5330 (Return of Excise Taxes Related to Employee Benefit Plans) with the IRS and pay a 15% excise tax on the value of the use of the money (i.e. on the interest rate, as if the plan loaned the deferrals to the employer).

Historically, many employers have been reluctant to use the VFC Program since it requires the employer to disclose administrative errors to government agencies, nor have they paid the 15% excise tax for both monetary and disclosure reasons.

Prohibited Transaction Exemption 2002-51

To alleviate some of the burdens mentioned above, the DOL published a prohibited transaction exemption (PTE 2002-51) in November 2002. Under this exemption, the failure to timely deposit 401(k) elective deferrals is not considered a prohibited transaction if certain requirements are satisfied. Specifically, the employer must: (1) deposit the contributions in the plan's trust no later than 180 days following the date of withholding; (2) the employer must successfully resolve the breach of fiduciary duty by utilizing the VFC Program; and (3) the employer must deliver notice to "interested persons" within 60 calendar days following the date of application. The notice must disclose the late contribution and explain the steps taken to correct the situation.

An employer may not utilize the exemption more than once during any three-year period.

It is the DOL's goal that employers will take advantage of the VFC Program to resolve the breach of fiduciary duty and thereby avoiding the prohibited transaction excise tax of 15%.

Form 5500 Annual Report

Another indication that the DOL has heightened its concern regarding the timely remittance of 401(k) elective deferrals came when line 4(a) of Form 5500, Schedules H and I were revised for 2002. Prior to 2002, line 4(a) read as follows:

> "Did the employer fail to transmit to the plan any participant contributions within the maximum time period described in 29 CFR 2510.3 -102?"

In 2002, the wording of line 4(a) was revised and the word "maximum" has been removed. Based on the prior wording, the preparer (employer) could indicate that deposits were not "late" (at least for purposes of answering the question), provided the employer deposited the deferrals within the "maximum" time period, interpreted as no later than the 15th business day of the following month. The revision to the schedules eliminates any further debate on this issue.

If an employer or third-party administrator determines that the applicable deposit time frame has been exceeded, CWF suggests they seek legal counsel regarding this matter.

New Retirement Plan Correction Programs CD-ROM Available for Free

A new CD-ROM explaining the programs provided by the IRS, the U.S. Department of Labor and the Pension Benefit Guaranty Corporation for retirement plan sponsors to correct retirement plan mistakes is now available. The CD includes detailed information on the IRS' recently released Revenue Procedure 2003-44 that contains the expanded and simplified Employee Plans Compliance Resolution Program or EPCRS. The importance of regular review of retirement plan operations is described in video clips on the CD. The U.S. Department of Labor self-correction programs for certain filing errors and specific financial transaction errors are detailed. Benefit professionals and payroll managers will find directions for submitting applications as well as copies of frequently used IRS forms and publications related to retirement plans.

A free copy of the new CD-ROM, *Retirement Plan Correction Programs,* is available online at www.irs.gov/ep. Look under "Topics" in the lower left-hand column and click on"Educational Services" to order Publication 4050.

(Taken from SSA/IRS Reporter newsletter, Fall, 2003)