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"The Pension Specialists"

Theft from 401(k)s & IRAs

The chance for an "unrecoverable" theft from 401(k) plans is a real possibility. The chance for an "unrecoverable" theft from an IRA is virtually nil if the IRA was established with an institution insured by the FDIC.

It is certainly possible that someone could steal a person's 401(k) funds. There is no governmental insurance program protecting 401(k) funds. In order to lessen the likelihood of theft, most 401(k) plans will require that there be two signatures required for most 401(k) plan transactions, but many small plans may not have this requirement.

Federal law requires an annual audit for 401(k) plans and other defined contribution plans covering more than 100 employees. Recent statistics of the Department of Labor indicate there are approximately 628,000 defined contribution plans. Of this amount, only 55,200 (8.8%) have more than 100 participants. The other 91.2% have less than 100 participants and are not subject to the audit requirements. There are requirements to file certain reporting forms.

More individuals than one would expect choose to leave their funds in a former employer's 401(k) plan. This may or may not be a prudent thing to do. Sometimes these employees leave their funds as a way to get back at their former employer. The law states that a person with a vested account balance of more than $5,000 cannot be forced by the employer to withdraw his or her funds.

If your institution wants more rollover deposits, you could suggest to your clients in such a situation that it might be in their best interest to move their funds into an IRA. The lure of the higher investment return may be off-set by the fact that he or she could lose their funds by theft.

The DOL has reported that last year there were 1,269 cases of funds or money found missing from 401(k) plans. The DOL and the IRS are certainly very aggressive in pursuing missing funds, but if the money was spent or lost in other investments, there may well be no money to recover.

IRAs are certainly better than 401(k) plans when it comes to risk of having such funds stolen.

Additional Discussion of the New Automatic IRA Rollover Rules

Application of the CIP Rules

These rules will apply, but only at the time the former participant or beneficiary first contacts the IRA Provider and exercises control over the account or asserts ownership. Compliance with the CIP rules will not be required at the time the plan administrator authorizes the direct rollover and establishes the automatic rollover IRA.

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Automatic IRA Rollover Rules,
Continued from page 1

Dual Role of Some Banks and the Safe Harbor Requirements

Many banks and other financial institutions serve as the trustee for many qualified plans. In many cases, a bank serves as the trustee for the bank's own qualified plan. A bank may also want to be the IRA Provider for the automatic and mandatory rollover distributions to be made by such qualified plans. One of the safe harbor requirements is that the qualified plan funds must be directly rolled over to a qualifying IRA.

A second safe harbor requirement is that the selection of an IRA, the IRA Provider and the investment product(s) cannot result in a prohibited transaction under section 406 of ERISA, unless there is an applicable exemption. Under existing law, a prohibited transaction would occur if a plan fiduciary received consideration from a financial institution in exchange for selecting that institution as the IRA provider, since this situation is not covered by either the statutory service provider exemption or an administrative exemption. However, the DOL has recently issued a class exemption which permits a financial institution to (1) select itself or an affiliate to serve as the IRA provider, (2) select its own investment products or funds, and (3) receive fees therefore.

The third safe harbor requirement is that there must be a written agreement between the plan administrator and the IRA Provider and such agreement must provide for the following. The investment product must be designed to preserve principal, earn a reasonable rate of return and also be liquid. There is to be a goal of retaining principal and income versus growth. The investment product must seek to maintain, over the term of the investment, the original rollover amount. The investment product must be offered by a bank or savings association as insured by the FDIC, a credit union as insured by the Federal Credit Union Act or an investment company registered under the Investment Act of 1940.

The fourth safe harbor requirement is that all fees and charges for establishing, maintaining, investing, distribution, termination, transfers and surrender charges shall not exceed the fees the same IRA provider has for "comparable" IRAs. The IRA provider will be able to charge for the services it provides to the automatic rollover IRA. However, the DOL reminds the IRA providers in a footnote that a prohibited transaction will be found under Code section 4975 if its fees and expenses exceed reasonable compensation within the meaning of Code section 4975(d)(2).

It appears that the requirement to preserve principal and provide a reasonable rate of return will not be violated even though reasonable fees are assessed.

The fifth safe harbor requirement is that the written agreement must expressly authorize a participant who becomes the IRA accountholder to have the right to enforce the terms of the IRA provider.

The Economics of Automatic Rollovers

The Number and Amount of Such Rollovers.

The DOL has estimated the number of mandatory lump-sum distributions of amounts between$1,001 and $5,000, to be 143,000 per year.

The DOL has estimated the number of distributions of $1,000 or less to be 88,000.

The DOL has estimated that the number of mandatory lump-sum distributions of amounts between $1,001 and $5,000, should be increased by 133,000, to reflect non-responsive participants.

The total number of such distributions is 361,000. The DOL has estimated the average rollover to be $2,000 per participant, or a total of $722 million per year.

Fees Which May Be Realized By IRA Providers

The typical fees for establishing an IRA were found to be in the range of $0 - $10. The maximum of such fees would be $3.6 million.

The typical fees for annual maintenance were found to be in the range of $7 - $50. The maximum of such fees would be $18.0 million.

The DOL did not furnish an estimate of investment fees, or termination charges and surrender fees, as they were found to be quite variable.

Procedures for Withdrawing a Mistaken or Excess Contribution

An IRA accountholder is, of course, entitled to withdraw a contribution at any time, if they are willing to pay the applicable taxes. However, there are many times an accountholder wishes to withdraw a current-year contribution because they have found they are not eligible to make the contribution, or they simply decided it was a mistake to make the contribution. An IRA custodian must be certain to handle this transaction correctly.

The accountholder has two options.

Option #1

An accountholder may withdraw the current-year excess/mistaken contribution. This withdrawal must be completed by the accountholder's tax-filing deadline (e.g. a contribution for 2004 made anywhere from 1-1-04 to 4-15-05 must be withdrawn by 4-15-05). The IRA custodian will want to document this withdrawal by using a form similar to CWF's Form #67 (reproduced later). In addition to the excess contribution, the interest attributable to the contribution must also be withdrawn. Because this calculation can be complex, CWF has created its Form #67 (Current Year) (reproduced later) to calculate this interest.

Note: If the accountholder is not yet age 59½, besides income tax, the accountholder will also owe the 10% additional tax on the interest attributable to a withdrawn contribution.

Example: If an accountholder made a $2,000 contribution in 2004, and withdrew the $2,000 plus $75 of related interest between 1-1-05 and 4-15-2005, he/she will include the $75 taxable interest in his/her 2004 income. However, because the contribution was withdrawn in 2005, the accountholder will not receive a Form 1099-R from their IRA custodian until January 2006. The rule is that the accountholder must pay tax on the interest in the year the contribution was made, not the year it was withdrawn, yet the custodian prepares the 1099-R based on the calendar year of the withdrawal.

Note: If the accountholder is not yet age 59½, besides income tax, the accountholder will also owe the 10% additional tax on the interest attributable to a withdrawn contribution.

Option #2

An accountholder may recharacterize a contribution to a traditional IRA to be a contribution to a Roth IRA, or vice versa. Under this option, the custodian will want to document the transaction using a form similar to CWF Form #54-TR (see February newsletter). On this form all parties involved acknowledge receipt of this form, which provides the details of the contributions being recharacterized. Again, the interest attributable to the recharacterized amount must also be calculated and be recharacterized. CWF has created its Form #67 (Recharacterization) (reproduced later) for this purpose.

The method used to calculate the interest on a recharacterized contribution is the same as the method used to calculate the interest related to the withdrawal of an excess/mistaken contribution.

Explanation of Governmental Reporting for a Recharacterized Contribution

Although it is not required, CWF strongly recommends that an IRA custodian provide the IRA accountholder with an explanation of the tax consequences and governmental reporting required of both the custodian and the accountholder. CWF has created Form #56-TREX for this purpose (see February newsletter).

The IRS requires the IRA accountholder to attach an explanation to their income tax return indicating the original contribution amount, the amount which was recharacterized, and the amount of earnings which was recharacterized. If, for example, the original contribution and recharacterization both occurred in 2004, you must include the gross amount recharacterized in your income for 2004. The taxable amount, however, will be zero.

What is a "Stretch" IRA?

The "stretch IRA" was a common term prior to 2001. A stretch IRA was one which allowed the longest payout period for a beneficiary after the IRA accountholder had died.

Prior to 2001, the rules governing required distributions from IRAs were set forth in proposed IRA regulations. The IRS chose to rewrite these proposed regulations in 2001. The IRS adopted new final regulations in April 2002. The new required distribution were changed substantially.

The old rules had concepts such as "recalculation" and "one year reduction" and single and joint distribution periods. If a person had elected to use the recalculation method over his or her single life expectancy, and this person died, then the old rules required a lump-sum distribution to the beneficiary(ies). On the other hand, if a person had elected to used a joint distribution period and the one-year reduction method, then the beneficiary would have been able to have distributions made to him or her over the longest period permitted by the tax laws. In general, this was the life expectancy of the beneficiary. Such an IRA was called a "stretch IRA."

Under the new RMD laws, the rules never mandate a lump-sum distribution just because the IRA account holder has died, nor even because an inheriting IRA beneficiary has died.

Once the IRA accountholder has died, the general rule is that the age of the beneficiary will be used to calculate the distribution period for himself or herself and all subsequent beneficiaries. For example, if the accountholder was age 75 when he or she died in 2005, and a son, age 49 is the beneficiary, then the distribution period which will apply to the son (and his beneficiaries if he should die before he depletes the IRA) will be as follows:

Year	Age	Distribution Period
2006	50	34.2 (from the Single Life Table)
2007	51	33.2 (34.2 - 1.0)
2008	52	32.2 (34.2 - 2.0)
2009	53	31.2 (34.2 - 3.0)

If the beneficiary is not a person (e.g. estate, school, church, etc), then the distribution period is based on the age (and life expectancy) of the deceased IRA accountholder determined as of the year he or she died. For example:

Year	Age	Distribution Period
2005	75	22.9 (from the uniform table)

The schedule to be used for subsequent years is based on the life expectancy of the IRA accountholder in the year of his or her death as set for in the Single Life Table. Since the accountholder died in 2005 at age 75, the initial factor is 13.4. This factor is not used for 2005, but it is used to calculate the distribution period for subsequent years.

Year	Distribution Period	
2006	12.4	(13.4 - 1.0)
2007	11.4	(13.4 - 2.0)
2008	10.4	(13.4 - 3.0)
2009	9.4	(13.4 - 4.0)

The Two-Year Excess Contribution Situation

Maggie Nacey contributed $500 on June 1, 2004. Maggie attained age 53 in 2004. On February 17, 2005, she contributed an additional $2,500 for tax year 2004. She comes to you (i.e. the IRA custodian) on March 23, 2005, and instructs you that she wishes to withdraw the entire amount of $3,000 under the excess contribution/current year rules.

What is Special or Different About this Situation?

There was a contribution in 2004 and another in 2005. The rule is that the income associated with the excess contribution must be withdrawn, and it will be taxable for the year in which (not for which) the contribution was made. This means then that some of the income will be taxable for 2004 and some will be taxable for 2005.

The earnings related to the $500 contribution made in 2004 will be taxable on the 2004 tax return. The IRS definitely wants the IRA custodian in this situation to prepare the *Special Explanation Regarding the Withdrawal of a 2004 "Current Year' Contribution* form

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Excess Contribution Situation, Continued from page 4

(or similar form) as set forth on page 6. Box 7 of the 2005 Form 1099-R will need to be completed with a reason Code P.

The earnings related to the $2,500 contribution made in 2005 (even though for 2004) will be taxable on the 2005 tax return. Box 7 of the 2005 Form 1099-R will need to be completed with a reason Code 8. In this situation, the IRS does not ask the IRA custodian to furnish a special form because the income is not taxable for the prior year. However, it certainly does not hurt to furnish the *Special Explanation Regarding the Withdrawal of a 2005 "Current Year" Contribution* form.

Summary. An IRA custodian must file a separate Form 1099-R for each different distribution code. Since the P and 8 are different, there will need to be two Form 1099-Rs prepared. In this special situation, one will be for 2004, and one will be for 2005.

Failed Recharacterization — Correctable or Not?

Assume a bank customer opened a Roth IRA in 2002, with a $3,500 deposit. The contribution which was made was for 2002. She then found out (before her tax-filing deadline), that she and her husband's 2002 income exceeded the limits allowed, and she was not eligible to make the $3,500 contribution. On or before October 15, 2003, this individual wanted to recharacterize the contribution to be a traditional IRA contribution. However, although the paperwork was completed to accomplish this recharacterization, the bank mistakenly left the funds in the Roth IRA. The error was brought to the bank's attention by the accountholder in early February 2005.

If the traditional IRA plan agreement and a "Notice of Recharacterization" form were completed and signed at the time the individual notified the bank of her desire to recharacterize the contribution in 2003 (the paperwork was completed at the time of the individual's request), then the bank can try to correct the error by an internal transfer from the Roth to a traditional IRA, using the current date. However, there is no guaranty that, should the IRS look further into this situation, they would agree with correcting the error in this way.

There may be an argument to make that the bank has the right to correct an error which it has made. There is an automatic waiver correction process for a bank error with respect to certain incomplete rollovers, and an institution could make the argument that the bank believed the IRS would make a similar provision for a bank's recharacterization error. Again, there is no guaranty that the IRS would agree.

There is no express IRS authority for correcting a failed recharacterization, as there is with correcting certain failed rollovers. If the institution adopts the position that it can correct this error, then the various 1099-R and 5498 forms for 2003 - 2005 will need to be revised to support the recharacterization. If the institution concludes that this mistake cannot be corrected by the bank, then the customer will have had an excess contribution for 2002, and, possibly, for 2003 and 2004. The 6% excise tax ($3,500 x 6% = $210) would be owed for each applicable year.

Rollover Rule Reminder

Many times customers are aware of a rule governing IRAs, but do not quite understand all the implications of such a rule. This is where your institution can be of excellent service to your customers — in helping them clearly understand the IRA rules. The situation of knowing the rule, yet using it improperly, could arise with the rollover rule. For a traditional IRA, the rule is that only one rollover is allowed per twelve-month period. We had received a consulting question concerning a bank customer who had taken multiple distributions during a year and expected to be able to roll over the total amount of these distributions.

Unfortunately, according to the rules, only one distribution would be qualified to be rolled over in a twelve-month period (of course, the 60-day rule must also be met). The remaining distributions would be taxable income to the individual in the year received. Obviously, it would be most beneficial to the accountholder to roll over the largest distribution, assuming the 60-day rule would be met.

Special Explanation Regarding the Withdrawal of a 2004 "Current-Year" Contribution

Custodian/Trustee: ____

Accountholder's Name: ____

Social Security Number: ____________________ **IRA Account Number:** ____________________

This form explains to you, the Accountholder, the complex rules for the withdrawal of a “current-year” contribution. A current-year contribution is one for which the tax deadline (plus extensions) has not yet passed. Thus, a contribution made at any time in 2004, for 2004, or between January 1, 2004, and April 15, 2005, for 2004 (during the carryback period) is considered a current-year contribution for 2004.

If you satisfy the following three (3) requirements, you will not be taxed on the withdrawal of a 2004 current-year contribution from your IRA.

1) You must withdraw the contribution by April 15, 2005, or such other date as is explained on the reverse side,

2) No deduction must have been allowed for the contribution for the tax year in question; and

3) Any interest or other income earned by the contribution must also be withdrawn. The interest or other income earned on this contribution must be included in your gross income, and the 10% additional tax on a distribution prior to age 59½ must be paid, if applicable.

Accountholder's Instructions to Withdraw and Signature

✓ On ____________________ (specify date) I contributed $__________ to my IRA account for the 2004 tax year. On this date ____________________, I hereby instruct you (the custodian/trustee) to withdraw $____________ plus the related income of $__________.

Signature of Accountholder ______________________________ Date ____________________

Special Explanation by Custodian/Trustee—
Because Action is Required by the Accountholder

✓ On ____________________ (specify date) we, as custodian/trustee of your IRA account, distributed to you, the accountholder, $____________ of which $__________ is the return of your contribution and $__________ is the related income (i.e. earnings/interest).

You must reflect on your Federal income tax return <u>all amounts</u> distributed to you. However, you will reflect two amounts on your Federal income tax return: the gross amount and the taxable amount. We expressly recommend that you consult with your tax advisor or preparer, or that you review IRS Publication 590. The following paragraphs discuss the Federal income tax consequences.

You have withdrawn a 2004 current-year contribution. You must reflect this distribution on the tax return <u>for the year in which you made the contribution</u> and not the year in which it was withdrawn, or for the tax year for which the contribution was made.

IRA #67 (4/04)* White—Custodian/Trustee Yellow—Administrator

Worksheet to Calculate the Income Related to the Withdrawal of a Current-Year Contribution(s)

Custodian/Trustee Information

Name ____
Address ____
City______________________________ State ______ Zip ______________
Attn: ________________________________ Phone ______________________

Accountholder

Name ____
Home Address ____
City ________________________________ County ______________________
State _________ Zip __________________ Date of Birth _________________
SSN ________________________________ Plan No. ____________________

IRA Account Information

Account Number ____

Type: ☐ Traditional ☐ Roth

Purpose: This form is used to calculate the interest or other income earned with respect to a current-year contribution which is being withdrawn under Internal Revenue Code section 408(d)(4). The formula set forth in IRC Regulation 1.408-4(c)(1) is being used.

Date of Contribution(s) ________________ ________________ ________________

Amount of Contribution(s) ________________ ________________ ________________

Date of Distribution ________________

1. Amount of Current-Year Contribution(s) to be Withdrawn. 1. ________________

2. Adjusted Closing Balance:
   a. FMV (immediately prior to withdrawal) 2(a). ________________
   (FMV = Principal + Interest + Accrued Interest)
   b. Distributions during computation period 2(b). ________________
   c. Total Adjusted Closing Balance (line 2a + 2b) 2(c). ________________

3. Adjusted Opening Balance:
   a. FMV (immediately prior to contribution) 3(a). ________________
   (FMV = Principal + Interest + Accrued Interest)
   b. Contributions during computation period 3(b). ________________
   c. Total Adjusted Opening Balance (line 3a + 3b) 3(c). ________________

4. Subtract line 3c from line 2c (this may be a negative number) 4. ________________

5. Divide line 4 by line 3c (a quotient to 4 decimal places) 5. ________________

6. Income (loss) Related to the Current-Year Contribution Being Withdrawn (multiply line 5 by line 1) 6. ________________

____ ____

Signature of Custodian/Trustee Date Signature of Accountholder Date

Additional Discussion – See Reverse Side

IRA #67-W (Current Year) (3/05)

Worksheet to Calculate the Income Related to a Recharacterized Contribution

Custodian/Trustee Information

Name ____
Address ____
City______________________________ State ______ Zip ______________
Attn: ________________________________ Phone ____________________

Accountholder

Name ____
Home Address ____
City ________________________________ County ____________________
State _________ Zip _________________ Date of Birth _________________
SSN ________________________________ Plan No. ___________________

IRA Account Information

Account Number ____
Type: ☐ Traditional ☐ Roth

Purpose: This form is used to calculate the interest or other income earned with respect to a current-year contribution which is being withdrawn under Internal Revenue Code section 408(d)(4). The formula set forth in IRC regulation 1.408A-5 Q&A2 is being used.

Date of Contribution(s) _______________ _______________ _______________

Amount of Contribution(s) _______________ _______________ _______________

Date of Recharacterization _______________

1. Amount of Current-Year Contribution(s) to be Withdrawn. 1. _______________

2. Adjusted Closing Balance:
   a. FMV (immediately prior to withdrawal) 2(a). _______________
      (FMV = Principal + Interest + Accrued Interest)
   b. Distributions during computation period 2(b). _______________
   c. Total Adjusted Closing Balance (line 2a + 2b) 2(c). _______________

3. Adjusted Opening Balance:
   a. FMV (immediately prior to contribution) 3(a). _______________
      (FMV = Principal + Interest + Accrued Interest)
   b. Contributions during computation period 3(b). _______________
   c. Total Adjusted Opening Balance (line 3a + 3b) 3(c). _______________

4. Subtract line 3c from line 2c (this may be a negative number) 4. _______________

5. Divide line 4 by line 3c (a quotient to 4 decimal places) 5. _______________

6. Income (loss) Related to the Current-Year Contribution Being Withdrawn (multiply line 5 by line 1) 6. _______________

_____________________________________ _____________________________________
Signature of Custodian/Trustee Date Signature of Accountholder Date

Additional Discussion – See Reverse Side

IRA #67-W (Recharacterization) (3/05)