THE Pension Digest

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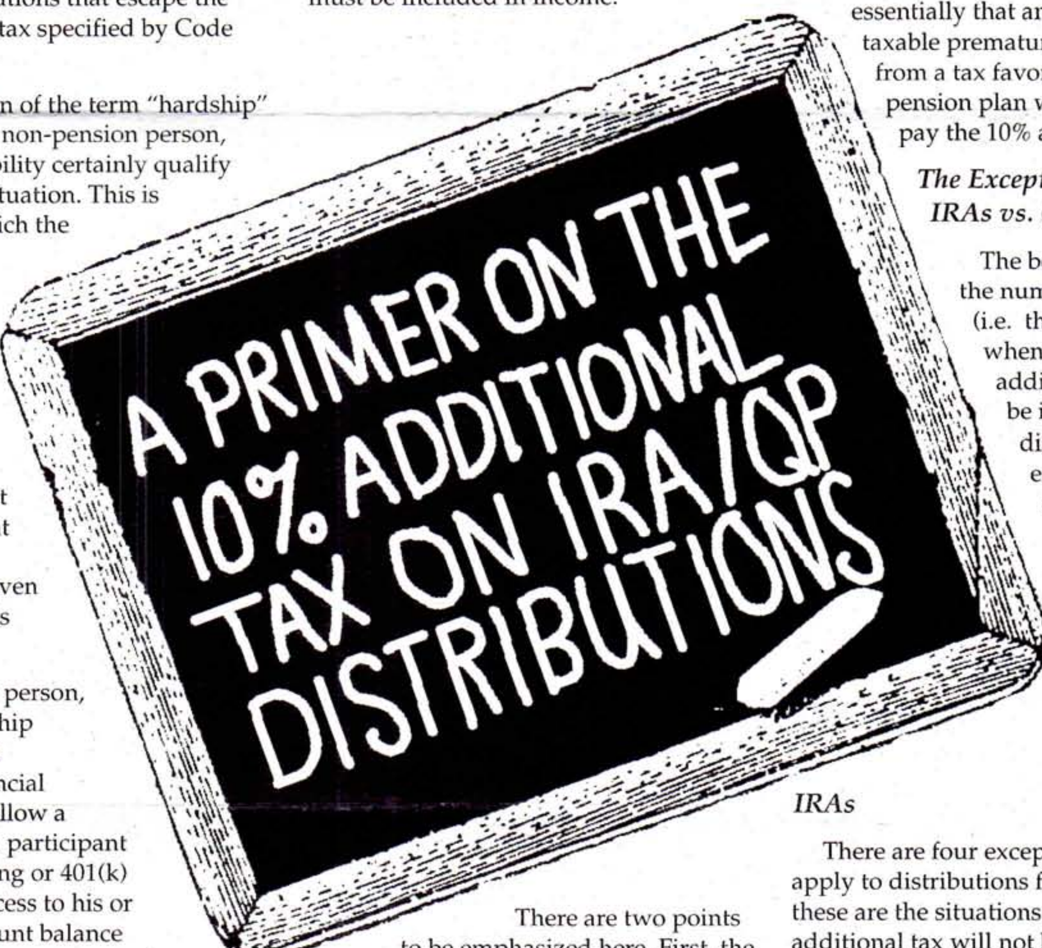

In last month's newsletter the topics of hardship and substantially equal periodic payments were discussed as types of distributions that escape the 10% additional tax specified by Code section 72(t).

A clarification of the term "hardship" is needed. To a non-pension person, death and disability certainly qualify as a hardship situation. This is the sense in which the term "hardship" was used in last month's newsletter. Payments on account of death or disability do not require payment of the 10% additional tax even if the recipient is under 59-1/2.

To a pension person, however, hardship means financial hardship. Financial hardship may allow a person who is a participant in a profit sharing or 401(k) plan to have access to his or her vested account balance prior to retirement or separation from service. But such a distribution to someone under age 59-1/2 is still subject to the 10% additional tax.

The purpose of this article is to summarize Code section 72(t) in its entirety.

The general rule of this Code section is that any taxpayer who receives a premature distribution from a "qualified retirement plan" must pay in addition to the regular tax an amount equal to 10% of the amount of the distribution which must be included in income.

There are two points to be emphasized here. First, the 10% tax only applies if the distribution must be included in income. This means the 10% additional tax does not apply to amounts rolled over, the return of most excess contributions, or the return of nondeductible contributions. Secondly, for these purposes a qualified retirement plan is defined to mean a qualified plan (money purchase, profit sharing, defined benefit, etc.) as defined in section 401(a), an IRA (whether an IRA account or annuity) or an annuity described in section 403(b).

Thus, the general rule is essentially that any one who has a taxable premature distribution from a tax favored IRA or pension plan will be required to pay the 10% additional tax.

The Exceptions: IRAs vs. Qualified Plans

The best way to discuss the numerous exceptions (i.e. those situations when the 10% additional tax will not be imposed) is to discuss the exceptions with respect to IRAs, and then the exceptions with respect to qualified plans.

IRAs

There are four exceptions which apply to distributions from IRAs. Again, these are the situations when the 10% additional tax will not be imposed.

1. Distributions made on or after the date on which the IRA accountholder attains age 59-1/2. This is the exception that most people use to escape the 10% additional tax.

2. Distributions made to a beneficiary or estate of an IRA accountholder. This is probably the second most common exception.

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3. Distributions to a disabled IRA accountholder. A person is considered disabled if he or she 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. In addition, a person cannot be considered disabled unless the person furnishes proof in the manner the IRS requires. A person can demonstrate disability by furnishing the IRA custodian/trustee with a Schedule R form which contains a doctor's certification of disability.

4. A distribution made in the form of substantially equal periodic payments. This subject was discussed in detail in last month's newsletter.

Qualified Plans

There are more exceptions to the 10% additional tax for distributions from qualified plans than from IRAs. Many of the exceptions are identical to those that apply to IRAs. But there are some additional ones and the rules are not always the same. Those situations when the 10% additional tax does not apply to QP distributions are described below.

1. As with IRAs, distributions made on or after the date on which the QP participant attains age 59-1/2.

2. As with IRAs, distributions made to a beneficiary or estate of a QP participant.

3. As with IRAs, distributions to a disabled QP participant.

(The above three are essentially similar to IRA rules.)

4. Distributions to a qualified plan participant in the form of substantially equal periodic payments, but only if on account of separation from service. For example, if he or she were an employee of L-Mart, Inc., and terminated employment he/she would be eligible, regardless of age.

5. Regular distributions to a QP participant made upon "separation from service" (leaving employment) after attaining age 55. Note that one can't separate from service before 55 and then obtain this exception after turning 55.

(This option is NOT available to IRA participants.)

The Separation-From-Service Requirement

WHAT DIFFERENTIATES THE ABOVE TWO EXCEPTIONS FROM IRAS, is the fact that PARTICIPANTS MUST SEPARATE FROM SERVICE in order for the exceptions to apply.

Who Can "Separate From Service?"

For most people it is easy to determine if they separate from service since they are employees, not owners. But such is not the case if a person is self-employed. For example, if the person farms or is a partner in a two-person tax preparation firm, could he or she retire at age 48 and immediately take a series of substantially equal payments, and not be required to pay the 10% additional tax?

Any of your self-employed customers in this position must confer with their own tax counsel because the law is unclear on this issue. The conservative approach is that a self-employed person cannot separate from service.

"Separation from service" has not been defined for Code section 72 purposes. This term has been defined for Code section 402 purposes (rollover rules). The rules of that Code section simply provide that a self-employed person cannot separate from service for lump sum purposes but can separate from service for partial distribution purposes. Again, the law is unclear whether a self-employed person can separate from service so that he or she can qualify to use these two exceptions to the 10% additional tax.

6. Distributions made to a QP participant to the extent such distributions do not exceed the amount allowable as a deduction under section 213 for amounts paid during the taxable year for medical care. This amount is determined without regard to whether the person itemizes deductions.

In some ways this is a surprising exception. The 10% additional tax will not be imposed if the person has medical expenses which qualify to be deducted under section 213. Conceptually, perhaps these pension distributions are considered to have been used to pay for these medical expenses and therefore it would not be right to impose the 10% tax on these amounts.

Any person who has a "premature" distribution from a qualified plan (or their tax preparer) should look to see if this exception will shelter some or all of the distribution from the 10% additional tax.

This exception does not apply to distributions from IRAs.

7. Distributions made to a former spouse or other alternate payee of a qualified plan participant are not subject to the 10% additional tax if the payment qualifies as part of a qualified domestic relations order (QDRO) under Code section 414(p)(l).

Again, this exception does not apply to distributions from IRAs. This means it also does not apply to SEP-IRAs. That is, the 10% additional tax will be assessed against a spouse who actually receives a portion of the former spouse's IRA or SEP-IRA unless they rollover the funds.

A Lost Exception

8. Distributions made to a QP participant when the distribution was from an ESOP (Employee Stock Ownership Plan). However, the ability to use this exception is past, since to qualify the distribution had to take place before January 1, 1990. In addition to the payout deadline some other technical rules had to be met. These rules will not be discussed here because this exception is now a "lame duck" exception.

Form 5329

When any of these exceptions apply, the taxpayer is required to complete and file Form 5329 (Return for Additional Taxes Attributable to Qualified Retirement Plan Including IRAs, Annuities, and Modified Endowment Contracts) with his or her Form 1040, and inform the IRS which exception applies so that the 10% additional tax is not charged.

Note that rolling over a distribution is not technically identified as an exception to the imposition of the 10% additional tax. But since the 10% tax applies only to amounts which must be included in income, it does not apply to rollovers since a rollover is not included in income.

It should also be noted that certain distributions to individuals in effect on December 31, 1986 were grandfathered in. That is, these individuals, even though not age 59-1/2 or not meeting any of the other exceptions, will not be subject to the 10% additional tax. Why? Prior to January 1, 1987 distributions to someone under age 59-1/2 were only assessed the 10% additional tax if the money came from an IRA. Distributions from a qualified plan were not assessed the 10% additional tax. Since there are payout schedules which had been set up assuming that the 10% tax would not apply, it was considered proper to grandfather them in.

The effect of these grandfather provisions is to create additional situations when the 10% additional tax will not apply. For further discussion of this grandfather topic, IRS Notice 87-13 should be reviewed.

Withholding Liability

The IRS in Notice 87-13 discussed the then-new rules of Code section 72(t). Much of the discussion has limited value since the ESOP rules no longer apply. The discussion, however, does emphasize that the payer or plan administrator is NOT liable to withhold any amount on account of the 10% additional tax, even though the taxpayer may have estimated tax liability because of it.

Very recently the Joint Committee on Taxation presented a report to the Ways and Means Committee on tax simplification measures. They recommended that Code 72(t) be changed so that the same rules apply to both IRAs and qualified plans. They proposed either deleting the special rules which apply to qualified plans, or extending these rules to apply to IRAs also.

The above discussion of Code section 72(t) has been presented to give an overview of those distributions which are not subject to the 10% additional tax. But as with all such matters, this is a tax issue which the customer or qualified plan participant must resolve with his or her tax advisor. The more informed you are, the better able you will be to provide this guidance effectively. Hopefully your customer/taxpayer will be able to structure distributions so that the 10% additional tax will not apply. PD

QP Trustee's Failure to Properly Transfer Funds to Participant's IRA Results in Fiduciary Liability

Appeals court reverses earlier ruling favoring trustee

(Editor's note: In the December, 1989 issue of The Pension Digest, we reported on the trial court decision in this case. That decision found in favor of a trustee, stating that a terminating plan participant did not adequately instruct the trustee as to the time frame for transfer (technically rollover) of plan funds. Absent specific instructions—the court held—the trustee had no duty under ERISA or the plan to rollover all the funds within one calendar year. The Appeals court reversal described below should put all trustees on notice that their responsibilities in plan administration may be more far reaching than they realize.)

The importance of a trustee responding prudently to a plan administration request by a plan participant, was emphasized in a recent decision by the U.S. Court of Appeals in Cincinnati. In this case, failure to respond satisfactorily resulted in the loss of tax-deferred status for a portion of the participant's funds, as well as their future earnings. The trustee was ultimately determined by the courts to have had fiduciary responsibility to the accountholder, which—the court determined—it failed to fulfill.

Case Details

This case - Warren et al. v. Society National Bank, June, 1990—began with a retirement plan participant requesting to withdraw his shares (permitted by the plan) and roll them over into a self-directed IRA, to continue their tax-deferred status. To do this, the plan funds HAD TO BE DISTRIBUTED in a lump sum WITHIN ONE CALENDAR YEAR.

The trustee, however, transferred part of the funds in one calendar year, and the balance in the subsequent calendar year. The result was tax liability on the funds distributed in the second year, which would not have occurred had the "same calendar year" requirement been met.

A Major Asset Loss

The participant contended that since the second-year funds lost their tax-deferred status, their future earnings would be taxed in the years earned, rather than at a future IRA distribution date. The participant argued that his pension investments therefore suffered significant asset reduction due to these income tax liabilities.

The trustee, however, prevailed in trial court, contending that the participant was seeking to recover extra-contractual damages, which ERISA (Section 502(a)(3)) does not allow. The Court further noted that the trustee was not given specific time frame instructions for transfer of the funds.

Court of Appeals Overrules, Awards "Compensatory" Damages

But the Court of Appeals ruled otherwise, finding that the participant was instead seeking "compensatory " damages, which were a direct result of the trustee's failure to fulfill its administrative contract by making a proper lump-sum distribution.

In making this ruling, the appellate court cited ERISA Sections 404(a) and 502(a)(3) as having incorporated the FIDUCIARY STANDARDS of trust law into ERISA, thus

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August 1st or October 1st for Correction Deadline? (IRS Notice 90-45)

The July newsletter indicated that August 1st was the deadline for submitting corrected filings of information returns so that the full $50 penalty would not apply. This deadline was established by the Revenue Reconciliation Act of 1989.

The IRS, however, in Notice 90-45 has now adopted the administrative policy of allowing "corrected" 1989 forms to use the October 1, 1990 deadline. The reason: the IRS instructions for the reporting forms printed prior to the law change still contain the October 1st deadline. Anyone using those forms would have presumed the deadline to be October 1st.

Thus, even though the law indicates the August 1 deadline, the IRS will use October 1,1990 as the deadline. This special deadline only applies to forms being corrected and not forms which were not originally filed.

For forms to be filed in 1991 the deadline will be August 1, 1991. PD

Solving a Rollover Dilemma

An individual resigned from partnership in a law practice. He wished to take a total distribution from the money purchase plan which the partnership maintained. He was not yet 59-1/2. The plan did permit payment to be made to him in lump sum within one year of his date of termination.

He wrote the IRS (letter ruling 8945053) because he wanted an express ruling that he could rollover his lump sum distribution to an IRA. He wrote the IRS because he wanted assurance that he was interpreting the provisions of Code section 402(a)(5) correctly. This section contains the rules for rollovers.

In order to be able to rollover funds the form of the distribution must either be a "qualified total distribution" or a "partial distribution." Both of these terms have special definitions.

A lump sum distribution as defined in Code section 402(e)(4) is one type of qualified total distribution. A lump sum distribution means the distribution or payment within one taxable year of the balance to the credit of an employee which becomes payable to the recipient (i) on account of the employee's death, (ii) after the employee attains age 59-1/2, (iii) on account of the employee's separation from service, or (iv) after the employee has become disabled. The plan must be "qualified" at the time of the distribution.

Special rules, however, stipulate that a self-employed person may not use the "separated from service" provision, and that only self-employed individuals may use the disability provision. These special rules are found in clauses (iii) and (iv) of section 402(e)(4)(A).

Thus, the partner in this situation cannot rollover the funds because his lump sum payment does not meet the definition of a qualified total distribution, since a self-employed person is not able to use the separation from service provision.

Can he roll over the lump sum payment by using the partial distribution rollover rules of Code section 402(a)(5)(E)? It may seem strange, but the answer is "yes".

A partial distribution is a distribution or payment within one taxable year to the recipient of an amount equal to at least 50% of the balance to the credit of an employee which becomes payable on account of the employee's separation from service, death or disability. Note that attaining age 59-1/2 does not qualify the recipient.

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A New Deadline for Prototype Submissions.

The IRS has once again extended the deadline for Master and Prototype submissions. The new (and hopefully last) deadline is December 31, 1990. The authority for this new deadline is found in IRA Announcement 90-89. The IRS is revising some sample plan language and believes the December 31 deadline will provide practitioners with additional time to analyze the requirements of the proposed regulations, and the revisions to the sample language.

Most institutions need not be concerned about this new deadline since their institution has already filed its revised prototypes (probably those of a mass submitter) to the IRS national office. However, if your institution has not yet made this filing and wants to, the IRS has graciously extended this deadline to December 31, 1990. Don't count on it being extended again. PD

Reader Survey Summary

In the June issue of The Pension Digest, we included a survey card with several questions pertaining to the satisfaction level, needs, and roles played by the financial institution personnel who receive our newsletter.

Now, as promised, we would like to summarize some of the things we learned from that survey, including some very appropriate suggestions from you for enhancing the value of The Pension Digest.

This is the kind of information that we will draw upon in our efforts to make The Pension Digest even more valuable to you in the future.

Newsletter Survey

Collin W. Fritz & Associates, Ltd., "The Pension Specialists"

Following are a series of BRIEF questions concerning The Pension Digest newsletter. In the interest of servi you better, we would greatly appreciate your help in analyzing just how well The Pension Digest meets you needs. Please fill in the blank next to each question, then drop in the mail to return to us. A sincere "thank you" for your help. *Michael Rahn, Publications Director*

1. Do you work with ☐ IRAs ☐ Qualified Plans ☐ Both?
2. How long have you worked with these services? _____ Years
3. Do you have supervisory responsibilities in this area? ☐ Yes ☐ No
4. At your institution, are retirement services of ☐ growing ☐ declining ☐ unchanged ☐ uncertain importance?
5. Do you read or "skim" most of the material in the Pension Digest? ☐ Yes ☐ No
6. At what level of understandability and "assumed knowledge" does The Pension Digest seem to be written? ☐ About right ☐ Too high (technical) ☐ Too low
7. Is mixing IRA and QP information in one newsletter acceptable? ☐ Yes ☐ No
8. Please recommend one improvement to The Pension Digest: ____________

Optional–Name ____________ Title ____________

Institution ____________ City ____________ State ____________

1. Do you work with ☐ IRAs ☐ Qualified Plans ☐ Both

52% said they worked only with IRAs.

48% said they worked with BOTH IRAs and Qualified Plans.

Frankly, we had expected a much higher proportion of the readership to say that they worked only with IRAs. But given the role that the survey recipients appear to play in their institutions (see later questions), perhaps this should be less surprising.

2. How long have you worked with these services?

Among those who worked only with IRAs, the average length of experience with the product was 6.9 years.

Among those who work with BOTH IRAs and Qualified Plans, the average is somewhat higher, at 10.2 years. This should not be too surprising, since Qualified Plans are considered to be more complex than IRAs.

Taken collectively, the average length of retirement plan experience of our survey respondents was 8.4 years. If these numbers suggest unexpectedly high levels of experience, it should be remembered that the survey recipients are not necessarily the "typical employee" of a bank's retirement plan department. This is supported by the next question.

3. Do you have supervisory responsibilities in this area?

More than 98% said they did. This might account for the lengthy experience levels, as reported in question #2. In the future, it would probably be enlightening to try to determine—within each institution—the average years of experience of all staff members there. More material for our next survey!

4. At your institution, are retirement services growing, declining, unchanged or uncertain?

Retirement plan services are definitely strong among institutions surveyed. 46% said they are growing, while another 46% said they are unchanged in importance. Only 5% said they are declining in importance, and 3% were uncertain.

Some of the reasons they are growing may include: (a) the importance of rollover and transfer transactions, which often represent LARGE deposit amounts; and (b) the concern that many Americans have about the ability of Social Security to adequately provide for their retirement plan needs. This also should be explored further.

5. Do you read or "skim" most of the material in The Pension Digest?"

The Pension Digest appears to be quite well read, at least among those with extensive responsibilities in the retirement sector of an institution. Less than 1% indicated they do not read or skim most of the publication.

6. At what level of understandability and "assumed knowledge" does The Pension Digest seem to be written?

Ninety percent felt it was written at a level that is "about right," while 7% felt it to be too technical. Three percent felt it was written at "too low" a level. This 3% could also have been due to imprecise wording or understanding of the question.

7. Is mixing IRA and Qualified Plan material acceptable in The Pension Digest?

Eighty-three percent said "yes," while 17% would prefer that the two be separated, either in a distinct publication, or segregated within each issue.

Although we have an appreciation for the position of those who never deal with such plans, the fact that so many respondents have SOME contact with qualified plans—with some commenting that they would like to learn more—suggests the value of this information to many. We will keep this issue under advisement.

8. Please recommend an improvement to The Pension Digest.

There were several that were mentioned often enough to impress us with their importance. These include:

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Question: What should I tell my IRA customer who wants me to provide her with detailed information on when a person is an active participant for IRA deductibility purposes?

✔ Answer. Of course, you will instruct her to see her tax advisor. However, you could refer her and her accountant to IRS Notice 87-16 which discusses in detail the issues as to when a person is an active participant for IRA deduction purposes.

Question: I thought we had until October 1st to get our corrections in to the IRS, but the July newsletter indicated it was August 1st? Do we have until October 1st, or will we be penalized if we missed the August 1st deadline?

✔ Please review the summary of IRS Announcement 90-45 found in this newsletter. The correct deadline was August 1, but the IRS decided to be "kind" and has given everyone until October 1 because the instructions printed on the forms indicated that October 1 was the deadline. These instructions were printed before the law changed. There will be no relief if you miss the August 1 deadline next year.

Question: An excellent customer of ours, age 48, notified us that his accountant had just been informed that the customer's IRA deduction claimed for 1989 had been disallowed, since he is a participant in his employer's profit sharing plan. Somehow the accountant missed this fact. The customer was otherwise qualified to make the contribution. The accountant has now said that he may withdraw his contribution as an "excess contribution." Is this correct?

✔ Your customer WAS ELIGIBLE to make this contribution since he was not 70-1/2, had sufficient compensation, and did not contribute more than the maximum IRA limit. The fact that the contribution was NOT DEDUCTIBLE is immaterial, and does not constitute a true excess. Since it is past the tax filing deadline for 1989, only a true excess contribution can be withdrawn, whereas before that date, ANY contribution could be withdrawn.

If your customer decides to take this distribution, it is our interpretation that you will have to use Code 1, "Premature – no known exception" when you prepare his W-2P or 1099-R form. Your customer and his accountant may present an argument to the IRS that this was an excess at the time his next tax return is filed. PD

The Pension Digest invites your questions and comments.
Please address to "Check It Out," Collin W. Fritz & Associates, Ltd., P.O. Box 426, Brainerd, MN 56401.

Survey — *Continued from page 5*

• Three-hole punch each issue for filing in a binder; design so that copy will not be lost when punched.

• Offer a special Pension Digest binder.

• Expand The Pension Digest in size.

• More on compliance issues as they relate to documentation.

• Continue to stress IRA reporting changes.

• Offer an index to aid in referencing topics in past issues.

These are all good ideas, and they will be considered in the coming months. We thank those of you who responded for your participation, and rededicate ourselves to making The Pension Digest an even better publication in the future. PD

Rollover Dilemma — *Continued from page 4*

How can the self-employed person use the "separated from service" provision under the partial distribution rules when he couldn't do so for a qualified total distribution? A special rule says you can! Section 402(a)(5)(D)(i)(I) of the Code provides in part that the second sentence of section 402(e)(4)(A)—the one that says the self-employed cannot use the separated-from-service provision—shall not apply to a partial distribution with respect to separation from service. In plain english, a self-employed individual may "separate from service" and still comply with the partial distribution rules.

Thus, the partner who had not attained age 59 1/2 at the time his total account balance was paid to him, may roll it over to his IRA. He cannot use the qualified total distribution rules, but he can use the partial distribution rules. PD

Fiduciary Liability — *Continued from page 3*

finding monetary damages an appropriate and equitable relief (ERISA Section 502(a)(3)(B)(i)) for breach of fiduciary duties.

A New Precedent?

It appears that—perhaps out of a desire to "keep employers honest," and motivate them to be informed and act in the best interests of their plan participants—fiduciary responsibilities in this case were interpreted in a broad and liberal way...fair warning, perhaps, to financial institutions and private businesses acting as plan trustees. PD