THE Pension Digest

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A Reminder of the Withholding Reminder Notice Requirement

A payor of an IRA or pension distribution has been subject to withholding requirements and rules since 1983. The Tax Equity and Fiscal Responsibility Act of 1982 first brought withholding with respect to IRA and pension distributions. IRA custodians and IRA trustees are such payors.

As of January 1, 1993, the law as it applied to the distributions from 401(a) qualified plans and 403(b) tax sheltered annuities was changed drastically. The rule now is — a payor must withhold 20% of the amount available for distribution if the distribution is one which is eligible to be rolled over (and most are), unless the person to be paid instructs that he or she wishes to have a direct rollover. A distribution which is a required minimum distribution, or one which is a part of a series of distributions of 10 years or more, is **not** eligible to be rolled over and is not subject to the 20% mandatory withholding rule. In general, a RMD distribution from a qualified plan is subject to withholding rules which are similar to those which apply to IRA distributions.

The basic rule for IRA withholding is — the payor (i.e. your institution) must withhold 10% of the amount distributed unless the person to be paid instructs you that he or she does not want withholding. That particular person's instruction to withhold or not withhold stays in effect for future distributions until that person instructs you that he or she wishes to reverse or revoke his/her previous instruction. However, the payor must still provide notice of the election and revocation procedures for subsequent distributions and must include a statement concerning tax liability for payment of estimated tax if the payee does not have withholding applied.

A financial institution needs to have an understanding of the withholding topics illustrated by the following questions:

1. Does your institution have liability if it fails to withhold the amount required to be withheld with respect to a distribution?

2. Does your institution have liability if it fails to pay (remit the funds which have been withheld) the IRS on time?

3. Does your institution have liability if it fails to submit the report summarizing the amount withheld from all the various IRA and pension distributions?

4. Does your institution have liability if it prepares a Form 1099-R but does so incorrectly since it errors in the reporting of the amount withheld?

5. Does your institution have liability if it fails to furnish a qualifying notice to a prospective payee?

6. Does your institution have liability if it fails to keep the records necessary to meet the Form 1099-R reporting requirements (this would include withholding)?

Except for #4, the answer is "yes" for each of the questions above.

The purpose of this article is not to discuss all of the withholding rules. This article is intended to be a **reminder** that a financial institution owes a "reminder withholding notice" to some of its IRA accountholders and QP participants who are receiving distributions. This question is a subset of question #5 above.

The use of the term "reminder" is our own terminology. We think this term is appropriate for many withholding notice situations since the financial institution's thought process is to furnish a notice for the first distribution and then to wonder what notice must be provided for subsequent distributions.

The answer is: a reminder or a subsequent notice. The rules which govern the reminder notice depend upon whether the distribution is from a qualified plan or an IRA and whether or not the distribution is periodic or nonperiodic.

The following situations illustrate most of the applicable rules.

Situation #1. You have an IRA account-

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ARE IRAS AND QPS EXEMPT FROM IRS LEVY?

Moneys within IRAs and qualified pension plans are available to the IRS via a levy, if taxes are owed.

So the answer to whether or not IRAs and QPs are exempt from IRS Levy is "no."

Because of the changes made by the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) and other public laws to section 6334, the IRS has recently issued a final regulation regarding property exempt from levy.

Code section 6334(a)(6) does provide that certain annuity and pension payments are exempt. Those annuity and pension payments which are exempt derive from the Railroad Retirement Act and those derived from the Army, Navy, Air Force and Coast Guard. Thus, annuities or pension payments which come from private pension plans or IRAs are not exempt.

The following statement was made by the IRS in the explanation of the new regulation. It is reproduced below because it states the IRS' position quite clearly.

"Explanation of Revisions and Summary of Comments

One commentator suggested that the final regulations provide that all retirement plans be exempt from levy. In fact, section 6334(c) provides that no property is exempt from levy other than property specifically enumerated in the Code." PD

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Special Warning — The Withholding Notice for Qualified Plan Distributions

In preparing the "reminder" withholding article we reviewed temporary regulation 35.3405-1. This regulation sets forth the withholding rules. These regulations with respect to qualified plans may be broken down into two sections: (1) the requirement of the payor to give a withholding notice and (2) the requirement of the plan administrator to actually withhold funds and remit them to the IRS unless the plan administrator has shifted the withholding responsibility to the payor by following the special listed procedures.

Many financial institutions have concluded (probably incorrectly) that they are fully complying with the withholding rules with respect to their qualified plan deposits and accounts since the plan administrator has not shifted to the payor (normally the financial institution) the responsibility to withhold.

We are concerned that many financial institutions have forgotten or never knew that they generally are responsible to furnish the withholding notice if they are the payor regardless that they may not be liable for the actual withholding.

The basic rules are set forth in D-3 and D-20 of the temporary regulation.

"D-3 reads:

D-3. Q. Who is required to provide notice to the payee of the payee's right not to have withholding apply?

A. Section 3405(d)(10)(B) requires the payor to provide notice to the payee of the payee's right to elect not to have withholding apply. Thus, even if the plan administrator has failed to transfer liability for withholding to the payor, the payor must provide notice to the payees.

D-20 reads:

D-20. Q. May the plan administrator provide the notice to payees on behalf of the payor?

A. The plan administrator may provide notice on behalf of the payor. However, the payor has sole responsibility for providing this notice whether or not the plan administrator has shifted liability for withholding to the payor, and if the plan administrator fails to provide adequate notice, the payor is responsible."

As the temporary regulation in Q/A D-3 and D-20 indicates, it is the payor who is responsible to furnish a withholding notice. The payor, however, is relieved of this duty if the plan administrator furnishes a proper withholding notice.

The payor normally will be the financial institution, but in some cases it could be the plan administrator or the plan trustee. The payor is the party who issues the check to the person in his or her status as a participant.

Thus, a financial institution making distributions from qualified plans must either be furnishing a complying withholding notice, be able to document that it has verified that the plan administrator is furnishing a complying notice or make sure that it is not the payor.

If the financial institution issues a check to a person who is in the status of being a participant after being so instructed by the plan administrator or trustee, then the financial institution is the payor.

If the financial institution issues the check to the trustee or plan administrator and then that party issues another check or endorses this check to the QP participant, then that party will be the payor and the financial institution will not be.

The real life problem arises with respect to the small qualified plans and especially the one-person plans. If a financial institution has decided it does not want to be the payor of a pension distribution, then it must make sure that when it issues a check that it makes the payee of the check, "Sally Smith as trustee of the Sally Smith Profit Sharing Plan" or "Sally Smith as plan administrator of the Sally Smith Profit Sharing Plan." It cannot make the payee of the check simply "Sally Smith" as that could mean Sally Smith as the participant.

It must also be understood that the duty of the plan administrator to furnish a section 402(f) notice is a separate and distinct requirement from the requirement of the payor to furnish the withholding notice. That is, there are two requirements. Certainly the plan administrator could (and probably should) handle both requirements on the same form, but a financial institution should not just assume that both requirements are being met. You would need to review the QP form being used to make sure it is handling the withholding requirement.

It goes without saying that since there are two separate requirements that there would be a separate penalty tax for messing up (not complying). As you will see, these taxes are virtually identical.

Code section 6652(h) sets forth the special taxes owed when a party fails to give the proper withholding notice as required by section 3405. The tax is $10 for each such failure, but the total amount imposed for all such failures during any calendar year shall not exceed $5,000.

Code section 6652(i) sets forth the special tax owed when a party fails to give the proper notice as required by section 402(f). The tax is $10 for each such failure, but the total amount imposed for all such failures during any calendar year shall not exceed $5,000.

In summary, it is quite clear that a financial institution, even though it generally does not have the duty and liability to withhold with respect to a qualified plan distribution, may well have the duty to furnish the withholding notice since it is the payor. A financial institution which fails to furnish the notice will then be liable for this failure assuming that the plan administrator also failed to furnish the proper notice. Solution: furnish the withholding notice, confirm that the plan administrator is furnishing the notice, or make sure you are not the payor. PD

Reminder—*Continued from page 1*

holder who is receiving monthly distributions. The person's age is not important. The person could be 53, 62, 68, 72, 85, etc. The critical fact is that this person is receiving monthly distributions. How often must you furnish a "reminder" withholding notice to this person and when must you furnish it?

Code section 3405(d)(10)(B)(i)(III) requires that the payor furnish its payees a notice of their right to change their previous withholding instruction/election not less frequently than once each calendar year.

Question and Answer F-27 of Temporary Regulation 35.3405-1 reads as follows:

"F-27. Q. When must notice of the right to elect not to have withholding apply be given as to designated distributions from an individual retirement account (IRA) described in section 408(a) that is payable on demand even though payments are scheduled to be made over a period greater than one year?

A. Under question F-15, designated distributions from an IRA that are payable upon demand are treated as nonperiodic distributions subject to withholding at the 10 percent rate even if the distributions are paid over a period certain. Section 3405(d)(10)(B)(i) requires the payor of a nonperiodic distribution to transmit to the payee notice, at the time of the distribution or at such earlier time as may be provided in regulations, of the right to elect not to have withholding apply. If distributions from an IRA have begun and are scheduled to be made at quarterly or more frequent intervals, then, in lieu of providing a notice at the time of each distribution, the payor may furnish a blanket notice applicable to all such distributions that are expected to be made to the payee from the account during a calendar year. Such a blanket notice must be furnished at a reasonable time before the first payment made in the calendar year to which the notice relates, except that a blanket notice relating to distributions from the IRA during 1983 may be made by the later of October 1, 1983, or the date of the first designated distribution from the IRA."

Note that "such blanket notice must be furnished at a reasonable time before the first payment made in the calendar year to which the notice relates ... " Thus, your institution will want to furnish its reminder notice in late December, 1994 or early January, 1995. Also note that F-27

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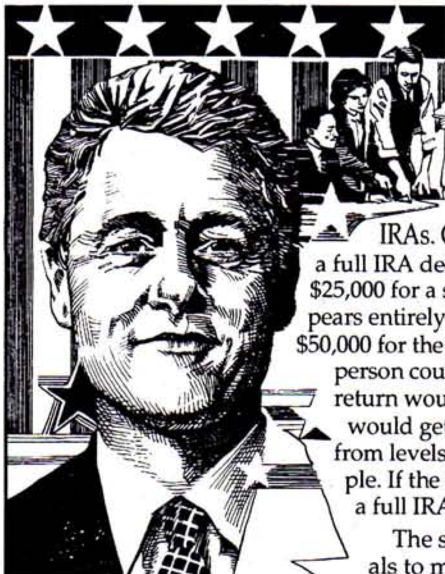

Clinton's IRA Proposal and What Experts Are Saying About The Change

President Clinton's proposed tax plan includes major revisions for IRAs. His proposal is actually a three-part plan.

The first part of his IRA proposal would double the current income levels for deductible IRAs. Currently, anyone who is a participant in an employer-sponsored retirement plan is eligible for a full IRA deduction only when their adjusted gross income is below a certain level. The current levels are $25,000 for a single person and $40,000 for a married couple filing a joint return. IRA deductibility disappears entirely for these people when the adjusted gross income level reaches $35,000 for a single person and $50,000 for the married couple filing a joint return. Clinton's proposal would increase these limits. A single person could take a full IRA deduction up to an income level of $50,000. A married couple filing a joint return would get a full deduction up to an income level of $50,000. A married couple filing a joint return would get a full deduction up to an income level of $80,000. The deduction limit would be phased out from levels of $50,000 to $70,000 for the single person and from $80,000 to $100,000 for the married couple. If the individual or neither spouse is in a retirement plan at work, the deduction limit would still be a full IRA deduction up to $2,000 a year.

The second part of Clinton's proposal would create a new IRA. This IRA would allow individuals to make nondeductible contributions to the IRA. Withdrawals from the IRA would be tax-free. What is unclear about this new IRA is how long the money in the IRA would have to remain in the account to remove it without tax or penalties.

The third part of the IRA plan deals with withdrawals from the IRA. Clinton has proposed that penalty-free withdrawals be allowed if the money is for retirement, college expenses, catastrophic medical bills, or buying a first home. The new Speaker of the House, Newt Gingrich, has also proposed IRA withdrawal rules very similar to these.

It appears the chance for IRA legislation in 1995 is very good. As was discussed in earlier articles in this newsletter, various Senators and Representatives in Congress have also said there will be IRA legislation in 1995 as part of any tax or budget bill. Clinton's proposals are very similar to many of the proposals coming from Republicans in Congress. Economic experts, for the most part, believe IRA legislation will occur. In his USA Today column, writer Mark Memmott stated the "Changes that make individual retirement accounts more attractive investments are certain." He also stated that he feels the final IRA plan will be more generous than what the President has proposed. Murray Weidenbaum, chairman of the Council of Economic Advisors under Ronald Reagan has said the Republicans won't "knock these IRA ideas."

It appears IRA legislation will happen in 1995. We will have to wait and see exactly what comes out of Congress and what gets signed by the President. Watch future issues of *The Pension Digest* for developments in this legislation. PD

Reminder—*Continued from page 2*

only applies if there are four or more distributions per year.

Also, be aware that Question and Answer D-32 of the Temporary Regulation indicates that it is **not** permissible to handle two years of notices at the same time. For example, it is not permissible to provide the annual notice on January 1, 1993, December 31, 1994 and January 1, 1995 and take care of 1994 and 1995 in the same mailing. The notice should be provided at approximately the same time each calendar year.

Situation #2. You have an IRA accountholder who is receiving only one distribution each calendar year. It is very common that an IRA accountholder who is subject to the required minimum distribution rules (past 70 1/2) wants to be paid his or her RMD amount only once each year.

A series of one distribution each year for all subsequent years is a periodic distribution in the usual meaning of "periodic." In order to simplify the calculation of the amount to be withheld, the temporary regulation at question and answer F-15 defined any IRA distribution which is payable upon demand (even if there is a periodic schedule) to be a nonperiodic distribution and thus subject to withholding at the rate of 10%.

The result of this special definition, and the fact that there are less than four payments per year, means the IRA custodian/trustee must comply with the notice rules which apply for nonperiodic distributions even though there is really a periodic distribution schedule. The temporary regulation provides that the IRA custodian must furnish the notice not earlier than six (6) months before the distribution and not later than a reasonable time before the distribution since you must give the person the opportunity to change their previous instruction/election. We would suggest a minimum of 30 days advance notice.

Situation #3. You have an IRA accountholder, age 74, who wants two distributions each year on July 5 and December 5.

The rules discussed above in situation #2 would apply. However, since there are two distributions, you would need to give two reminder notices.

Situation #4. You have a qualified plan participant who instructed you two years ago to pay from her profit sharing plan her required minimum distribution amount on December 18 of each year.

You would need to furnish her a withholding "reminder" notice. In general the rules discussed in situation #1 would apply. That is, notice must be given once each calendar year and should be given at approximately the same time each year. The requirement to furnish the notice before the first distribution of that year does not apply since that is an IRA rule.

It should also be noted that the "reminder" notice form must be specifically drafted for qualified plans. That is, a form drafted only for IRAs should not be used to handle the "reminder" task for QPs.

Another difference from IRAs should be noted – one payment per year, two payments per year, three payments per year and four payments or more per year, are all treated as periodic under the rules which apply to QP distributions. This means the once per year notice requirement applies to all of these QP distributions.

Summary. An IRA custodian/trustee must comply with the withholding rules which require you to furnish a notice allowing an IRA accountholder or beneficiary (i.e. the payee) to revoke the previous withholding instruction/election which he or she furnished you. Similar rules apply with respect to distributions from a qualified plan to a QP participant.

Please be aware that CWF has at least three IRA forms (Forms 59B, 59C and 59D) which can be used to accomplish the IRA "reminder" notice function and has recently designed a new QP "reminder" notice form (Form 859). PD

✔✔✔ Check It Out ✔✔✔

Question: What form or forms should an IRA custodian or trustee be sure to gather for its file when it receives a direct rollover contribution.

✔ Answer. The IRA custodian/trustee wants to obtain a signed copy of the section 402(f) notice and election form which the QP plan administrator is required to furnish the terminating QP participant. The reason is – the QP plan administrator is now required to inform the QP participant what portion of his or her distribution is eligible to be rolled over. If you cannot obtain a copy of this notice and election form, then you should have the person sign a rollover certification form.

Question: Do the Truth-In-Savings rules apply to IRAs?

✔ Answer. Yes. A financial institution which acts as an IRA custodian must comply with the Truth-In-Savings rules for IRA savings and time deposit accounts.

Question: Does the IRS Form 5305-SEP contain an error since it still mentions the amount of $30,000 as being the contribution limit?

✔ Answer. No. The form reads, "the lesser of 15% of compensation or $30,000." This statement is not technically in error since the lesser of the two is 15% of compensation (which is now limited to $150,000). Fifteen percent of compensation is $22,500 which is less than $30,000. The IRS probably should have changed this provision as it appears to confuse many people.

Question: Our institution accepts SEP deposits. Would you recommend that we use a service agreement to make clear to our SEP customers that we do not perform any administrative services, and that these needs must be met by the SEP plan administrator (employer) or their tax advisor.

✔ Answer. Yes. We feel it is very important to use a service agreement. The tax problems which arise when SEP plans have not been properly administered are truly horrendous. SEPs are simple, but not so simple as many employers think. Many times they exclude people who are required to be covered and many times someone does not receive the allocated contribution to which they are entitled.

Question: Is it possible for a person to be allocated more than $22,500 under a QP or SEP plan, or a combination of plans?

✔ Answer. Yes. It is possible for a person to be allocated more than $22,500 for at least three reasons. The $22,500 is arrived at by multiplying the compensation limit of $150,000 by the employer's tax deduction limit of 15% of compensation. The first reason is that the employer may sponsor one plan (profit sharing or money purchase) which is integrated with social security. Secondly, the employer may sponsor a money purchase plan with a 25% deduction limit which would have a contribution rate higher than 15% (i.e. 16% to 25%). The third reason is that the employer could sponsor a profit sharing plan and a money purchase plan or a SEP plan and a money purchase plan.

Question: We had a QP participant, David Justice, who died with a balance of $18,400. David's beneficiary is his spouse, Ann-Marie. She has decided that she will have $5,000 paid to her on December 28, 1994 as this amount qualifies for the death benefit exclusion and the remaining $13,400 Marie wants directly rolled over into an IRA she will establish. The QP trustee should prepare how many 1994 Form 1099-Rs and how should they be completed?

✔ Answer. Two. They should be completed as follows. The IRS' instructions with respect to handling the death benefit exclusion have never been that clear as to how to report the $5,000 amount in boxes 1 and 2. The 1994 instructions for Form 1099-R appear to say that this amount should be included in boxes 1 and 2.

9898 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code		1 Gross distribution	OMB No. 1545-0119	Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.
First National Bank 111 Main Street Anytown, USA 11111		$ 5,000.00	1994	
		2a Taxable amount $ 5,000.00		
		2b Taxable amount not determined ☐	Total distribution ☒	Copy A For Internal Revenue Service Center
PAYER'S Federal identification number	RECIPIENT'S identification number	3 Capital gain (included in box 2a)	4 Federal income tax withheld	
11-1111111	111-11-1111	$ 0.00	$ 0.00	File with Form 1096.
RECIPIENT'S name Ann-Marie Justice		5 Employee contributions or insurance premiums $	6 Net unrealized appreciation in employer's securities $	For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
Street address (including apt. no.) 222 Cedar Avenue		7 Distribution code 4B / IRA/SEP ☐	8 Other $ %	
City, state, and ZIP code Anytown, USA 11111		9 Your percentage of total distribution %		
Account number (optional)		10 State tax withheld $ $	11 State/Payer's state no.	12 State distribution $ $
		13 Local tax withheld $ $	14 Name of locality	15 Local distribution $ $

Form 1099-R Cat. No. 14436Q Department of the Treasury - Internal Revenue Service

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9898 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code		1 Gross distribution	OMB No. 1545-0119	Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.
First National Bank 111 Main Street Anytown, USA 11111		$ 13,400.00	1994	
		2a Taxable amount $ 13,400.00		
		2b Taxable amount not determined ☐	Total distribution ☒	Copy A For Internal Revenue Service Center
PAYER'S Federal identification number	RECIPIENT'S identification number	3 Capital gain (included in box 2a)	4 Federal income tax withheld	
11-1111111	111-11-1111	$ 0.00	$ 0.00	File with Form 1096.
RECIPIENT'S name Ann-Marie Justice		5 Employee contributions or insurance premiums $	6 Net unrealized appreciation in employer's securities $	For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
Street address (including apt. no.) 222 Cedar Avenue		7 Distribution code G / IRA/SEP ☐	8 Other $ %	
City, state, and ZIP code Anytown, USA 11111		9 Your percentage of total distribution %		
Account number (optional)		10 State tax withheld $ $	11 State/Payer's state no.	12 State distribution $ $
		13 Local tax withheld $ $	14 Name of locality	15 Local distribution $ $

Form 1099-R Cat. No. 14436Q Department of the Treasury - Internal Revenue Service

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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.

CWF's Summer Conference

September 10-13

Topics include: *Qualified Plans* • *IRAs* • *New Legislation*

More information to follow!