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

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Special Tax Relief for IRAs to be used by Hurricane Sandy Victims

The IRS is trying to help Hurricane Sandy victims as much as possible. The federal laws, however, are limited as to the relief which can be provided. See the related article, General Discussion of Special IRS Relief Rules and Procedures.

It is very possible and likely that in the tax legislation being discussed during the fiscal cliff negotiations there will be special tax relief provisions for the Hurricane Sandy victims as there was in prior years for Hurricanes Katrina, Rita, Wilma, the storms in Kansas and the storms/floods in the Midwest.

In Announcement 2012-44, the IRS provides for limited relief for those individuals wanting to take IRA distributions by providing that less strict distribution procedures may be used.

Those individuals qualifying for relief are those who live or worked in the disaster areas and also those individuals who do not live or work in the disaster areas, but who will use their IRA funds to help a family member who lived or worked in the disaster areas.

But an IRA custodian will not want to lessen its distribution procedures too much. For example, normally a distribution would not be made to a beneficiary until a death certificate has been provided to the IRA custodian. Because of the IRS relief, the IRA custodian could make a distribution without being furnished the

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Special Tax Relief For 401(k), 403(b) and 457(b) plans so Hurricane Sandy Victims May be Helped

In times of natural disasters, victims of disasters will benefit by having access to cash. One possible source of such cash for individuals is 401(k), 403 (b) and 457(b) plans.

The general pension tax rule is – a participant of one of these plans may not take a partial or total distribution of his or her vested account balance until he or she separates from service or reaches age 59$^{1}/_{2}$.

However, these plans may be written to provide for two methods of making cash available. First, a plan may be written to permit a participant to take out a loan from the plan or his or her plan account. There are, of course, certain rules applying to such loans. There are loan limits, there may be collateral limits and the plan may define for what purposes a loan may be taken. Second, a plan may be written to permit a participant to take a hardship distribution. Again, there are certain rules or conditions which must be met in order for a plan to make a hardship distribution to an individual. Normally, a participant will certify that he or she meets the requirements for a loan or a hardship distribution and then the plan administrator verifies such certification.

In Announcement 2012-44 the IRS has issued guidance providing relief from the normal verification procedures applying

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death certificate as long as the plan administrator makes a reasonable attempt to obtain the death certificate as soon as possible.

The IRS has also adopted relief procedures under regulation section 301.750A-1(c)(1) and Revenue Procedure 2007-56 for affected taxpayers.

The effect of the IRS relief is that certain tax acts that had a deadline between October 26, 2012 and February 1, 2013, now have the deadline of Friday, February 1, 2013. Some examples.

1. A person impacted by Hurricane Sandy withdrew $12,000 from her IRA on September 6, 2012. Her 60-day rollover period would have ended on November 5, 2012. Her rollover period now ends on February 1, 2013. She in essence, is given a longer rollover (i.e. short term loan) period.
2. A person impacted by Hurricane Sandy withdrew $44,000 from her IRA on November 6, 2012. This was after Hurricane Sandy. Her 60 day rollover period would have ended on January 5, 2013. Her rollover period now ends on February 1, 2013. She, in essence, is given a longer rollover (i.e. short term loan) period.
3. An IRA custodian impacted by Hurricane Sandy will have a deadline of February 1, 2013 and not January 31, 2013, to furnish 2012 Forms 1099-R, 5498, fair market value statements and RMD notices. Other IRS forms would also have a deadline of February 1, 2012.
4. Many IRA accountholders and beneficiaries must be paid a required distribution by December 31, 2012. Those impacted by Hurricane Sandy now have until February 1, 2013 to be paid their 2012 RMD. There will be some individuals who fail to take out their 2012 RMD by December 31, 2012. They will be able to avoid the 50% tax if they have a family member who is entitled to relief because of Hurricane Sandy.

Individuals choosing to use these special relief rules to take their 2012 RMDs in 2013 must understand that a distribution is taxed in the year it is received. The special relief rules do not change this rule.

In summary, as a result of Hurricane Sandy, there are special relief rules applying to IRAs. In some cases, an accountholder will wish to use these special rules, in other cases a beneficiary may wish to use these special rules and in other cases, an IRA custodian/trustee may wish to use these rules. As discussed above, the IRA accountholder or beneficiary is not required to have worked or lived in the disaster area in order to be eligible to use these special relief. ◆

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to loans and hardship distributions. And the IRS has issued other relief also. The intent of this relief is to make cash available to the participant as soon as possible.

For the first time that CWF is aware of, the IRS is allowing a person who is a family member of an individual who was in the disaster area to use these special relief procedures. The only requirement – the individual taking out a plan loan or a hardship distribution must use it to assist a daughter, son, parent, grandparent or other dependent who lived or worked in the disaster area.

Of course, a person who did live or work in the disaster area on October 26, 2012, is able to use the special relief procedures. See the article setting forth disaster areas.

To gain this relief, a person must take a hardship distribution and/or a loan by February 1, 2013.

The relief provided by the IRS – a plan administrator will not need to perform the standard verification tasks. The plan administrator is able to rely upon representations for the individual (employee or former employee) as to the need for and the amount of the hardship, unless there would be actual knowledge to the contrary.

Hardship distributions may be made from a person's elective deferrals under a 401(k), 403(b) or 457(b) plan, Hardship distributions may not be made from QNEC or QMAC accounts or from any earnings.

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Hardship distributions may also be made from a profit sharing or stock bonus plan even though it does not currently contain any provision authorizing a hardship distribution or a loan.

Hardship distributions may not generally be made from a defined benefit pension plan or a money purchase plan. An exception exists if an employee has contributed his or her own funds or has made a rollover and such funds are accounted for separately.

The IRS has stated that the plan administrator is able to treat a distribution on account of Hurricane Sandy as a hardship distribution even though the plan document does not define a natural disaster as an event qualifying one for a hardship distribution. And the IRS has stated that a person taking a Hurricane Sandy hardship distribution is not required to cease elective deferrals for 6 months as is the normal rule when one takes a hardship distribution.

Plans will be allowed to use these special hardship and loan rules even though the plan has not yet been amended to authorize such distributions or loans. Such an amendment must be adopted by the last day of the first plan year commencing after December 31, 2012.

The IRS has also authorized more liberal distribution procedures for plan loans and distributions from any retirement plan, including IRAs. The IRS has stated that it will not find fault with a plan if it fails to follow the standard procedural requirements applying to loans and distributions. The plan may make a loan or a distribution between October 26, 2012, and continuing through February 1, 2013, without following all of the normal documentation rules. However, there is no modification of the normal spousal consent rules, if applicable. And there is no discussion of any change in the federal income tax withholding rules.

The plan administrator or the IRA custodian must make a reasonable attempt to gather the documentation which was not originally furnished as soon as practicable after February 1, 2013. The intent of this relief is to make cash available to the participant as soon as possible, An example is furnished. Normally a distribution would not be made to a beneficiary until a death certificate has been provided the plan administrator or the IRA custodian. Because of this relief, the plan administrator or the IRA custodian could make a distribution without being furnish the death certificate as long as the plan administrator makes a reasonable attempt to obtain the death certificate as soon as possible.

When a participant takes out a loan, the receipt of the funds is not taxable income to the recipient unless he or she defaults on the loan. When a participant takes out a hardship distribution, this distribution generally must be included in the income of the participant and the 10% pre-age 59½ tax will be owed unless an exception is met. Current law does not provide an exception to the 10% for a distribution used to pay expenses associated with a natural disaster. It will be interesting to see if the fiscal cliff tax bill will add such an exception to the tax laws.

In summary, the IRS has provided special relief allowing sponsors of certain retirement plans to make loans and hardship distributions to people impacted by Hurricane Sandy. We at CWF believe that some employers will choose to use this special relief, but some will not. Again, the cardinal rule is, the plan document must authorize the transaction. The IRS is giving employers over a year to amend their plans if they would choose to provide these relief provisions to their plan participants. ◆

Localities of Victims of Hurricane Sandy

So far, IRS relief applies to the following localities:

Connecticut: Fairfield, Middlesex, News Haven and New London counties and Mashantucket Pequot Tribal Nation and Mohegan Tribal Nation located within New London county;

New Jersey: Atlantic, Bergen, Burlington, Camden, Cape May, Cumberland, Essex, Gloucester, Hudson, Hunterdon, Mercer, Middlesex, Monmouth, Morris, Ocean, Passaic, Salem, Somerset, Sussex, Union and Warren counties;

New York: Bronx, Kings, Nassua, New York, Orange, Putnam, Queens, Richmond, Rockland, Sullivan, Suffolk, Ulster, and Westchester counties; and

Rhode Island: Newport and Washington counties. ◆

General Discussion of Special IRS Relief Rules and Procedures

The federal tax laws give the IRS broad authority to grant tax relief when the President declares a disaster and FEMA designates an area or areas for assistance. This authority is set forth in Code section 7508A. The IRS has chosen to give special relief on account of the heavy devastation.

The primary relief given by the IRS is to extend the time a taxpayer has to file various tax returns and pay the tax owing. In determining whether the performance of a tax act has been timely, the IRS has the authority to grant extensions of up to one year. The IRS has two designations. Those areas with the most severe damage are designated as an area to receive Individual Assistance. Those areas which did not incur as severe damage are designated as an area to receive Public Assistance. The covered disaster area is comprised of those entitled to receive Individual Assistance and Public Assistance.

What Relief Has the IRS Given to the Affected Taxpayers?

1. There is a postponement until the various dates specified in the prior article for each act listed in regulation section 301.7508A-1(c)(1) and Rev. Proc. 2007-56 for affected tax payers, if the last day to perform the act would otherwise fall between the indicated dates.

   Regulation section 301.7508-1(c)(1)(iii) provides the postponement on rules for making certain IRA and qualified plan contributions, making certain distributions, recharacterizing IRA contributions or making a rollover under section 402(c), 433(a)(4), 403(b)(8), or 408(d)(3). Thus the regulation expressly covers rollover to an IRA. For example, if Jane Doe withdrew $8,000 from her IRA on October 25, 2012, (i.e. just before a storm hit and she resided in one of the counties), then her 60-day rollover period would normally have been up in December. This special extension rule gives her until the new deadline date of February 1, 2013, to recontribute these funds as a rollover contribution.

Any act not expressly covered by the Regulation may be covered by Rev. Proc. 2007-56. It is 23 pages in length. It lists many tax acts which are postponed. Some examples.

1. Secs. 408(i) and 6047(c): A trustee or issuer of an individual retirement arrangement (IRA) must provide certain information concerning the IRA to the IRA owner by January 31 following the calendar to which the information relates. In addition, IRA contribution information must be furnished to the owner, and Form 5498 filed with the IRS, by May 31 following the calendar year to which the information relates.

   CWF Observation. This deadline does change from January 31, 2013, to February 1, 2013 for those institutions qualifying to use the Hurricane Sandy relief rules.

2. Secs. 401(a)(9), 403(a)(1), 403(b)(10), 408(a)(6), 408(b)(3) and 457(d)(2): The first required minimum distribution from plans subject to the rules in section 401(a)(9) must be made no later than the required beginning date. Subsequent required minimum distributions must be made by the end of each distribution calendar year.

   CWF Observation. Those individuals allowed to use the Hurricane Sandy relief procedures and who have an RMD deadline of December 31, 2012, now have a revised deadline of February 1, 2013.

3. Treas. Reg. §§ 301.9100-2(b)-(d): An automatic extension of 6 months from the due date of a return, excluding extensions, is granted to make the regulatory or statutory elections whose due dates are the due date of the return or the due date of the return including extensions (for example, a taxpayer has an automatic 6-month extension to file an application to change a method of accounting under Rev. Proc. 2002-9, provided the taxpayer (a) timely filed its return for the year of election, (b) within that 6-month extension period, takes the required corrective action to file the election in accordance with the statute, regulations, revenue procedure, revenue ruling, notice or announcement permitting the election, and (c) writes at the top of the return, statement of election, or other form "FILED PURSUANT TO section 301.9100-2."

   CWF Observation. This is the special rule which allows excess IRA contributions to be corrected or

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recharacterized by October 15th. This deadline does not change for these storms.

4. A person set up under a substantially equal periodic payment schedule to receive a distribution during a relief period would have a revised deadline.

Who Is Entitled to Receive the Tax Relief?

The following individuals and entities qualify as affected taxpayers and are entitled to tax relief:

1. An individual whose principal place of residence is located in the covered disaster area;
2. An individual whose principal place of residence is NOT located in the covered disaster area, but who has a family member who did reside in the covered disaster area and who will use the withdrawn IRA funds to assist this family member.
3. An individual whose principal place of residence is NOT located in the covered disaster area, but whose tax records necessary to meet a filing or payment deadline are located in the covered disaster area;
4. An individual whose principal place of residence is NOT located in the covered disaster area, but whose tax professional or practitioner is located in the covered disaster area;
5. An individual, who while visiting the covered disaster area, was killed as a result of the storm and its aftermath. In this situation, the decedent's estate is considered to be the affected taxpayer. If injured, the individual is the affected taxpayer.
6. Any spouse of an affected taxpayer, if a joint income tax return will be filed for, or on account of, the couple.
7. Any relief worker assisting in the relief activities in the covered disaster area, even though this person is not affiliated with a government or philanthropic organization;
8. A business entity whose principal place of business is located in the covered disaster area;
9. A business entity whose principal place of business is NOT located in the covered disaster area, but whose tax records necessary to meet a filing or payment deadline are located in the covered disaster area.
10. A business entity whose principal place of business is NOT located in the covered disaster area, but whose tax professional or practitioner is located in the covered disaster area; and
11. Any estate or trust that has tax records necessary to meet a filing or payment deadline in the covered disaster area.

The IRS relief granted with respect to the disaster situations applies to all the counties and parishes listed. The IRS makes clear that FEMA has the authority to add additional counties and parishes which would be eligible for Individual and/or Public Assistance as a result of the wreckage caused by a storm. An IRA custodian and IRA accountholders should be on watch to see if new counties or parishes are added.

In the counties and parishes designated for Individual Assistance, relief will be granted automatically, but the IRS strongly encourages the taxpayer to mark or highlight their tax returns in such a way as to inform the IRS of the need for relief. The IRS suggests that the taxpayer should identify the storm in red letters on the top of their return or on the top of any other documents as filed with the IRS.

In the counties and parishes designated to receive Public Assistance relief, such relief is not automatically granted to all taxpayers. The IRS will grant the relief if they are notified of the need for relief. Taxpayers will need to mark their tax returns as discussed above.

Affected taxpayers other than those living in counties or parishes entitled to Individual Assistance or Public Assistance may also be eligible for the tax relief. But they, too, do not receive the relief automatically. They, too, must inform the IRS they need the special relief. They do so by filing and marking their tax returns as discussed above.

It is to be noted that an affected taxpayer entitled to relief may be a person located outside the covered disaster area. ◆

How to Administer CESAs on January 1, 2013

As of January 1, 2013, the maximum CESA contribution will be $500 be child and not the $2000 per child applying for 2012 if there is no new tax bill, As discussed below, there are numerous other CESA rules which revert to the 2001 rules on January 1, 2013 unless there is a new tax bill extending these rules.

Coverdell Education Savings Accounts (CESAs) are caught up in the fiscal cliff tax negotiations, Although we expect that there will be a tax bill enacted in 2012 and/or 2013 extending the CESA provisions or making them permanent, there is no certainty of such an extension or that the CESA rules in effect for 2002-2012 will be made permanent. If a new tax bill extending the CESA rules for 2013 and subsequent years is not signed into law by December 31, 2012, then the CESA laws revert to the laws in effect for 2001 as of January 1, 2013.

There is no need for a financial institution to overreact to this unwanted situation but a financial institution will need to decide how it will administer its CESA accounts until Congress and the President settle this situation.

Presumably, the IRS will issue guidance soon on this or any other tax provision set to expire on December 31, 2012. But one sees every day how far behind the IRS is with issuing updated tax forms. As of November, 30, 2012, very few of the tax forms needed to file a person's 2012 tax return have been finalized let alone other tax forms.

The IRS model tax forms, Form 5305-EA (Coverdell Education Savings Custodial Account) and Form 5305-E (Coverdell Education Savings Trust Account) were last revised in October of 2010 and they state the maximum contribution limit is $2,000. There is no mention of the $500 contribution limit or any of the other 2001 laws.

CWF's CESA plan agreement forms have mentioned the fiscal cliff, situation. for CESAs since December of 2011. CWF will revise its other CESA administrative forms once more is known about possible law changes.

The IRS does need to issue guidance because this situation is a tax and compliance mess.

The general rule is that the CESA plan agreement must be followed. But it mentions that a $2,000 contribution is permissible when the law says otherwise.

A financial institution will want to decide whether it will limit a contribution to $500 (this is what CWF recommends until the IRS furnishes additional guidance) or whether you would permit continued contributions of $2,000. Later, if necessary, the extra $1,500 could be withdrawn as an excess contribution. And a CESA custodian/trustee may wish to put the responsible individual and/or the designated beneficiary withdrawing CESA funds in 2013 on notice that the distribution taxation rules applying to 2013 are not as tax-friendly as the rules which applied for 2012. He or she may wish to consult with their tax advisor.

Set below is an explanation of the 2001/2013 rules if there is no new tax legislation.

1. The contribution limit for 2013 will be $500 per child rather than $2,000 per child.

2. An individual will no longer be able to make a carryback CESA contribution by April 15 of the following year. A 2013 contribution would have to be made by December 31, 2013.

3. A married person filing a joint income tax return for 2013 is eligible to make a $500 per child contribution if their joint income is less than $150,000, no contribution if their joint income is more than $160,000 and a prorated contribution if their income is between $150,000 and $160,000. In 2012 the income range is $190,000-$220,000 rather than $150,000 - $160,000.

4. The special rules enacted with respect to individuals with special needs will no longer exist. This means no contribution may be made for an individual once he or she attains age 18. Any assets remaining in a CESA must be distributed when either one of the following two events occurs. First, the designated beneficiary reaches age 30. He or she must be distributed the remaining assets within 30 days after the attaining of age 30. Secondly, if the designated beneficiary dies before reaching age 30, he or she must generally be distributed the

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remaining assets within 30 days after the date of the death. There is an exception for a transfer to a surviving spouse or a family member, In such case, the new designated beneficiary will not be required to withdraw the assets until he or she reaches age 30. A person with special needs is required to close the CESA at age 30 just like others must.

5. A family member is again defined as set forth below, In 2013 first cousins no longer qualify as a family member for CESA transfer and rollover purposes.

Members of the beneficiary's family. The beneficiary's spouse and the following individuals (and their spouses) are members of the beneficiary's family.

- The beneficiary's child, grandchild, or stepchild.
- A brother, sister, half brother, half sister, stepbrother, or stepsister of the beneficiary.
- The father, mother, grandfather, grandmother, stepfather, or stepmother of the beneficiary.
- A brother or sister of the beneficiary's father or mother.
- A son or daughter of the beneficiary's brother or sister.
- The beneficiary's son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister- in-law.

6. The correction of excess CESA contributions will again be subject to the same rules applying to excess IRA contributions (i.e. April 15th plus extensions) and will not have the special correction deadline of May 31.

7. The definition of qualified education expenses will be radically changed by reducing the expenses which will qualify. Expenses must again arise from “higher” education, meaning post-high school, college and post-graduate. No longer will withdrawals used for certain elementary and secondary education expenses qualify. And it will no longer be so clear whether or not computer related expenses will qualify. Set forth below is the IRS discussion of this topic in the 2001 version of Publication 970. Such discussion will again apply for 2013.

Qualified education expenses. These are expenses required for the enrollment or attendance of the designated beneficiary at an eligible educational institution. The following items are qualified education expenses.

1) Tuition and fees.
2) The cost of books, supplies, and equipment.
3) Amounts contributed to a qualified state tuition program. (See chapter 8, Qualified State Tuition Programs.)
4) In some situations, the cost of room and board.

The cost of room and board is a qualified education expense if the designated beneficiary is at least a half-time student at an eligible educational institution.
The expense for room and board is limited to one of the following two amounts.

1) The school's posted room and board charge for students living on campus.
2) $2,500 each year for students living off campus and not at home.

Designated beneficiary. The individual named in the document creating the trust or custodial account to receive the benefit of the funds in the account is the designated beneficiary.

Eligible educational institution. An eligible educational institution is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the Department of Education. It includes virtually all accredited, public, nonprofit, and proprietary (privately owned profit-making) postsecondary institutions. The educational institution should be able to tell you if it is an eligible educational institution.

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Half-time student. A student is enrolled "at least half-time" if he or she is enrolled for at least half the full-time academic work load for the course of study the student is pursuing as determined under the standards of the school where the student is enrolled.

8. There will no longer be coordination with a Qualified Tuition Program. There again will be a 6% excise tax on contributions made by a person to a child's CESA where a contribution was also made to a qualified tuition program for the same child.

9. There will no longer be coordination with the Hope Scholarship Credit and the Lifetime Learning Credit. In 2012 it is possible for a person to claim these credits in the same year tax-free withdrawals are taken from the CESA as long as there are sufficient education expenses. In 2013, the rule again is - cannot claim either credit if there was a tax-free distribution from a CESA.

In summary, the changes made to the CESA rules in 2001 were favorable changes, encouraging their establishment and use. However, other tax law changes promoted the use of qualified tuition program over CESAs. Changing the CESA rules back to the 2001 rules will not be welcomed. Congress must decide soon if it is worthwhile to keep CESAs using the pre-2002 rules, keep CESAs using the 2002-2012 rules or create new rules for 2013 and future years. CWF will keep you informed. The concept of saving for education expenses is one which should be promoted as long as the tax costs are reasonable.

Tax History

In June of 2011, President Bush signed the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Initially, the law changes were to apply only to 2002-2010. Some provisions of EGTRRA were made permanent (e.g. the IRA pension law changes) unless there would be a future repealing law.

Other provisions, including CESAs, had to be extended. This was done in December of 2010 when President Obama signed into law the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. Section 101 of Title I of this law created the authority to extend until December 31, 2012, the many tax laws contained in EGTRRA 2001 which had not yet been made permanent, including numerous law changes impacting Coverdell ESAs. ◆

An RMD Planning Technique that Doesn't Work

An IRA custodian recently called with the following situation. Jane Doe, the IRA accountholder, had an IRA CD set to mature on December 5. The maturity value is $45,000. She has IRAs with other financial institutions. Her combined RMD total for 2012 is $11,000. An employee with another financial institution in the same locale has told Jane Doe that she may withdraw the $45,000, she then could put it into her checking account which she also has with the other institution and later in January she could make a rollover contribution of $34,000. And because the $34,000 was not in an IRA as of December 31, 2012, it will mean her 2013 RMD will be smaller than it otherwise would have been.

This planning technique to reduce one's RMD for the upcoming year does not work. The RMD regulation has been written to require an adjustment to the fair market value as of the preceding December 31 for any outstanding rollover or transfer. When an IRA custodian receives a transfer or a rollover contribution between January 1 to March 1 (and the distribution occurred in the prior year) and the contributor is or will be age 70½ or older this year, an IRA custodian will want to double-check to make sure the RMD calculation does take into account the outstanding rollover or transfer contribution made after December 31. We would not be surprised that the IRA RMD software is not this sophisticated. ◆