Matt W. Zeigler
Zeigler & Associates, P.C.
ATTORNEYS AND COUNSELORS AT LAW
Phone: (248) 643-9530 • Fax: (248) 643-0843 • E-Mail: matt@zeiglerlaw.com

NEW WITHHOLDING TAX ON PENSION PAYOUTS

By: Matt W. Zeigler, Esq.

There are new mandatory tax withholding rules on distributions from retirement plans. Effective January 1, 1993, a retirement plan must withhold 20% of payouts to plan participants unless certain new requirements are met. These new requirements were included in the "Unemployment Compensation Amendments of 1992" (Public Law 102-318) ("Act") signed into law on July 3, 1992.

In late October, the IRS published Temporary Regulations which outlined the provisions that will be effective in January, 1993. These regulations outline the mandatory tax withholding rules on plan distributions.

Essentially, the Act changes the way distributions have been handled in the past. The old rules were that a plan could, on the election of the participant, pay the entire account balance to him or her without any income tax withheld from the distribution. Now, that election is no longer permitted.

The new rules:

- mandate a 20% withholding rate on any eligible rollover distribution that the participant does not elect to have paid into another retirement plan in a direct trustee-to-trustee transfer or rollover;
- direct that plan participants be provided with a direct transfer provision in their plan;
- charge plan administrators with the responsibility to provide written notice of the Act's new rules to participants within a reasonable time before a distribution is made;
- enlarge the types of rollover distributions from qualified plans and tax-deferred annuities; and
- establish plan administrator and employer liability for filing the returns, reports and Forms 1099-R.

DIRECT TRANSFER PROCEDURES. The required 20% withholding tax applies to tax deferred retirement plan distributions eligible for rollover that are not transferred directly to an eligible transferee plan. Plan participants may not elect out of the withholding as they have in the past for lump sum distributions on termination of employment or on periodic payments.

In order to avoid the withholding rules, a direct transfer from the plan making the distribution to the plan receiving the money must be made. In the past, a plan could make the distribution to the plan participant and, if made within 60 days, the participant could then deposit the money into his or her own Individual Retirement Account (IRA). The new rules require that the distribution check of the individual participant's account balance be negotiable solely by the trustee of the recipient plan in order avoid the withholding requirements.

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20% MANDATORY WITHHOLDING. The new IRS regulations, provide that if property (other than employer securities) is distributed and the cash in the distribution will not satisfy the withholding obligation, an employer must either sell the property or receive cash from the employee in amount sufficient to pay the withholding. If the rollover is not, in fact, paid to an eligible retirement plan, the plan administrator (the employer in most cases) will not be liable for failing to withhold taxes on a distribution if the employer reasonably relied on adequate information provided by the participant.

NOTICE PROVISIONS. The new regulations, require that a written notice be given to each distributee "within a reasonable time before making an eligible rollover distribution". A "reasonable time" means given at the same time as the notice to spouses regarding their rights of consent on benefit payouts.

The model notice, as drafted and published by the IRS, is approximately 3 to 4 pages is length. Copies of the proposed notice to the distributees is available at the offices of MGA upon request by contacting MGA at 1-800-292-7832.

EXCEPTIONS TO THE WITHHOLDING RULES. The new rules provide certain exceptions to the mandatory withholding rules. Some of the exceptions are:

- Periodic distributions to participants made over any one of the following periods: the life of the employee, the joint lives of the employee and the employee's spouse, or a specified period of 10 years or more. (Note, however, if periodic distributions were made in the past, the 20% withholding rules do apply to the periodic payments made in 1993, unless the payments fall into this exception.);
- Mandatory minimum distributions as required when a participant reached age 70 1/2;
- Amounts distributed that are less than $200;
- Distributions to participants of eligible employer securities;
- Distributions to pay for the costs of life insurance coverage ("PS-58" costs);
- Corrective distributions of excess contributions in 401(k) plans;
- Dividends paid on employer securities; and
- Plan loans that are treated as distributions.

ACTION STEPS. The Act added a new section to the Internal Revenue Code, 401(a)(31). This new section requires that, as a condition of continuing plan qualification, existing retirement plans which do not have these mandatory withholding rules stated in them must be amended to include these provisions. The time period in which to amend these plans is not later that the last day of the 1994 plan year with retroactive application covering all distributions from and after January 1, 1993.

CONCLUSION. This is just a thumbnail sketch of the new regulations. Please contact MGA for a copy of the Notice. Also, for specific questions, or an inquiry into the special transition rules, please contact your professional advisors.

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