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INDIVIDUAL RETIREMENT ACCOUNTS

Robert E. Craine*

When President Ford signed into law the Employee Retirement Income Security Act of 1974 (ERISA)¹ on September 2, 1974, he not only instituted the first comprehensive set of regulations for the private pension system in the United States,² but simultaneously, he provided a greater degree of equality of retirement savings tax treatment for the approximately thirty million employees in the total work force who did not have available to them a retirement savings program with tax incentives. While the coverage by corporate retirement plans and self-employed individuals' plans has grown rapidly from the four million employees covered in 1940 to the approximately thirty million plus covered today,³ there remains a substantial segment of the work force

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1. Pub. L. No. 93-406, 88 Stat. 829, 1 U.S. CODE CONG. & AD. NEWS 935 (1974).

2. Most of the major labor legislation of the twentieth century has affected to some degree the various aspects of pension plans (i.e., the National Labor Relations Act (1935), 29 U.S.C. §§ 151 *et seq.* (1970); the Labor Management Relations Act (1959), 29 U.S.C. §§ 141 *et seq.* (1970)). However, the Welfare and Pension Plans Disclosure Act of 1958 (29 U.S.C. §§ 301 *et seq.* (1970)) was the first federal legislation specifically designed to regulate pension and welfare funds. For various reasons the protection Congress was attempting to provide by these laws failed. A statement in H.R. REP. NO. 533, 93d Cong., 2d Sess. (1973) to the effect that "[t]he assets of private plans, estimated to be in excess of \$150 billion, constitute the only large private accumulation of funds which have escaped the imprimatur of effective federal regulation," indicates the congressional mood during the gestation period of pension reform. Thus, when ERISA was passed, there were three sets of federal law, which attempted in various degrees to regulate the private pension system—the INT. REV. CODE OF 1954, §§ 401-04, 501-03, the Welfare and Pension Plans Disclosure Act (29 U.S.C. §§ 301 *et seq.* (1970)) and the Labor Management Relations Act (29 U.S.C. § 141 *et seq.* (1970)). Due to the uncoordinated and ineffective regulation imposed by these laws, ERISA was born. However, the IRA provisions grew out of a desire to enhance horizontal income tax equality by providing new vehicles for individual retirement savings, and to promote pension fund portability.

3. H.R. REP. NO. 807, 93d Cong., 2d Sess. 296 (1973); 3 U.S. CODE CONG. & AD. NEWS 4678, n.3 (1974).

that is not covered by the present system. Somewhere in the vicinity of one-half of all employees in private, nonagricultural employment are not covered by retirement plans, and retirement plans are still relatively rare among small business firms and in agriculture. In addition, overly restrictive age and service requirements for participants in corporate and self-employed plans have characteristically excluded many employees. Thus, potentially forty million⁴ Americans may be able to benefit from the individual retirement account (IRA) legislation.

Moreover, if the utilization is as great as expected the potential revenue loss from these new provisions for IRAs will be approximately \$225,000,000 for 1974 and as much as \$355,000,000 for 1977 and thereafter.⁵ This is 68 percent of the total revenue loss expected from all of the ERISA provisions designed to equalize the tax treatment for taxpayers regarding retirement savings plans.⁶ Thus, the IRA provisions will potentially affect more Americans than any other provision of ERISA, and will mean the largest revenue loss to the Government. Including those potentially eligible to use the pension roll-over provisions, the IRA provisions affect the entire work force.

Congress had two distinct and somewhat unrelated purposes in mind when the IRA provisions were drafted. The individual retirement savings programs with tax incentives were developed with the congressional purpose of enhancing the measure of horizontal tax equality among all taxpayers; likewise, the pension fund portability concept promotes this idea, as well as encouraging the growth of the private retirement savings system and aiding the development of a mobile work force. This article will deal with the various aspects of ERISA designed to implement both of these concepts—the investment IRA and the roll-over or conduit IRA.

INVESTMENT IRA

Conceptually an individual retirement account is a fund or accumulation of money or other assets created by an individual for the general purpose of saving and investing for the future. An IRA must be maintained pursuant to a written instrument which creates a trust or custodial account as the device by which the funds are accumulated and

4. Alexander, *Up the IRA*, BARRON'S, vol. 55, no. 11, at 5 (March 17, 1975) estimated forty million people eligible for IRA participation (copy of article available but not dated).

5. See H.R. REP. No. 807, 93d Cong., 2d Sess. 284 (1973); 3 U.S. CODE CONG. & AD. NEWS 4708 (1974).

6. *Id.*; the total revenue loss from all ERISA provisions designed to equalize tax treatment is projected at \$520 million.

managed.⁷ Generally, a bank⁸ must be the trustee or custodian of the account, but there is a provision allowing "other persons" to act as trustee or custodian if they satisfy the Secretary of the Treasury that they will administer the account according to the rules set forth in the Internal Revenue Code.⁹ In order for a "person," other than a bank or other qualified financial institution,¹⁰ to serve as the trustee of an IRA, he must file a written application with the Commissioner of Internal Revenue.¹¹ The applicant must meet the same requirements set forth in the regulations under section 401(d)(1), relating to nonbank trustees of pension and profit sharing trusts benefiting owner-employees.¹² Generally, the new regulations provide that a potential nonbank trustee must demonstrate his ability to act within the accepted rules of fiduciary conduct, experience and competence with respect to accounting for the interest of a large number of individuals, and familiarity with activities normally associated with the handling of retirement funds. The regulations also contain extensive net worth and financial responsibility provisions. Particularly noteworthy is the requirement in the temporary regulations that the applicant assure, in its application, the uninterrupted performance of its fiduciary duties, notwithstanding discontinuity in its ownership. The regulations state that this requirement precludes an individual from applying to be an IRA trustee.¹³

An IRA must be established for the exclusive benefit of an individual or his beneficiary.¹⁴ While this provision ostensibly parallels the traditional qualified retirement plan concept, it remains to be seen whether and to what extent the same interpretations will be made in the IRA context.

7. INT. REV. CODE OF 1954, §§ 408(a), (h) [hereinafter cited as CODE].

8. Bank as defined in CODE § 401(d)(1).

9. CODE §§ 408(a)(2), (h).

10. On July 25, 1975, President Ford signed Senate joint resolution 102 (Pub. L. No. 94-60 (July 25, 1975)) allowing federally chartered savings and loan associations to act as custodians of IRAs. State savings and loan associations can also act as IRA trustees or custodians. (12 U.S.C. § 1464(5)(c) (1975)).

11. Under the Employee Retirement Income Security Act of 1974—Certain Trustees of Individual Retirement Accounts—40 Fed. Reg. 53580 (1975), the proposed regulations are substantially the same as the temporary regulations under the same heading, Proposed Treas. Reg. § 1.408-2, 40 Fed. Reg. 53593 (1975).

12. 26 C.F.R. §§ 11.401(d)(1)-1 (1975); Temporary Income Tax Regulations Under the Employee Retirement Income Security Act of 1974—Nonbank Trustees of Pension and Profit Sharing Trusts Benefiting Owner-Employees, 40 Fed. Reg. 48508 (1975); the proposed regulations are substantially the same, Proposed Treas. Reg. § 1.401, 40 Fed. Reg. 48514 (1975).

13. 26 C.F.R. §§ 11.401(d)(1)-1(c)(i) (1975).

14. CODE § 408(a).

Only cash contributions may be made to an investment IRA, and each individual is limited to a maximum \$1,500 contribution for each taxable year.¹⁵ One of the tangible tax benefits to be derived from an IRA and the making of contributions thereto is the income tax deduction allowed by section 219 of the Internal Revenue Code as amended by ERISA. A deduction is allowed for IRA contributions in arriving at adjusted gross income,¹⁶ but the amount is limited to the lesser of: (1) an amount equal to 15 percent of the compensation includable in an individual's gross income for the taxable year, or (2) \$1,500.¹⁷ Thus, there are ostensibly two different rules relating to the amount which may be contributed to an IRA. However, for all practical purposes, Code section 4973 imposes the lesser of 15 percent of compensation or \$1,500 limitation by virtue of the imposition of an excise tax on contributions over the amount deductible under Code section 219.¹⁸ This excise tax on excess contributions does not apply if the individual distributes the amount of such excess contribution on or before the date his income tax return is due for the same taxable year.¹⁹

Similar to the provisions of ERISA regarding the nonforfeiture of accrued benefits derived from employee contributions under qualified corporate retirement plans,²⁰ but contrary to the provisions of most corporate retirement plans which provide varied vesting schedules for employer contributions, the IRA provisions require that the entire balance of an IRA be nonforfeitable at all times.²¹

The rules relating to the distribution of IRA funds are similar to those for HR-10 or Keogh plans: IRA funds must be distributed to the beneficiary of the trust no later than the close of the taxable year in which he attains age 70½, or by that date the distribution must have begun, to extend over a certain period based on the remaining life or life expectancy of the beneficiary or the remaining life or life expectancy of the beneficiary and his spouse.²² Failure to distribute the required amount results in the imposition of a tax on the payee (beneficiary) equal

15. CODE § 408(a)(1).

16. CODE § 62(10). This means the deduction is allowed regardless of whether a taxpayer uses the standard deduction or itemizes his deductions.

17. CODE § 219(b)(1).

18. CODE § 4973 imposes a 6 percent excise tax on contributions in excess of those deductible under CODE § 219.

19. CODE §§ 408(d)(4), 4973(b)(2).

20. CODE § 411 provides as a condition of a qualified status that a corporate plan must not allow the forfeiture of employee contributions.

21. CODE § 408(a)(4).

22. CODE § 408(a)(6).

to 50 percent of the amount by which the minimum required to be distributed during such year exceeds the amount actually distributed.²³ Associated with this provision is the rule imposing an excise tax on all amounts distributed from an IRA prior to the date the individual for whose account the IRA was maintained attains the age of 59½²⁴ or becomes disabled.²⁵ Finally, the beneficiary or beneficiaries of an IRA distributee who dies prior to receiving his entire interest in the account, must receive the account balance within five years after the death of the distributee or an immediate annuity must be purchased.²⁶

INDIVIDUAL RETIREMENT ANNUITIES AND QUALIFIED RETIREMENT BONDS

Basically, the rules governing IRAs are applicable to the other two individual retirement benefit devices introduced by ERISA. Considering first the possibility of using an Internal Revenue Service (IRS) approved annuity or endowment contract issued by an insurance company,²⁷ the deductions, contributions and distribution limitations are parallel in all respects, except with regard to basic differences based upon the investment medium. Consistent with the IRA philosophy, only the retirement savings element in the endowment contract is deductible while the portion of the premium used to purchase life insurance is not.

A comparable retirement savings program can also be funded through the purchase of a qualified retirement bond.²⁸ Bonds issued under the Second Liberty Bond Act²⁹ must be placed in an individual retirement savings account; and the rules relating to contributions, deductions and distributions are substantially the same as those relating to the ordinary individual retirement account. These two optional individual retirement devices have been mentioned for completeness. Inasmuch as the provisions governing individual retirement annuities and qualified retirement bonds are parallel in most respects to the "regular" IRA rules, the emphasis throughout this article is on the "regular" IRA.

23. CODE § 4974(a).

24. CODE § 408(f)(1).

25. CODE § 408(f)(3).

26. CODE § 408(a)(7).

27. CODE § 408(b).

28. CODE § 409.

29. Act of Sept. 24, 1917, ch. 56, 40 Stat. 288 (codified in scattered sections of 31 U.S.C.).

LIMITATIONS

No deduction is allowed for an IRA contribution for any taxable year if, for any part of such year, the individual on whose behalf the contribution was made was an active participant in another "qualified retirement plan" (this category includes corporate, self-employed and government retirement plans, and Code section 403(b) annuities).³⁰ In addition to many questions on the interpretation of the provision itself (*i.e.*, what is or is not an "active participant?"), there is a basic policy question relative to this exclusionary concept. Apparently, this provision, like other "revolutionary" legislative proposals, was the result of compromise and conservatism. Part of the administration's proposal for an increased national savings program included modifying the IRA concept so that persons could establish IRAs and contribute tax deductible dollars to them, to the extent that they were not receiving annual contributions on their behalf to a corporate plan under which they participated, in an amount equal to the IRA limitations. The objective, of course, was to bring the total contributions for retirement savings on behalf of an individual up to the IRA maximum level of \$1,500. The \$1,500 limitation is under attack as being too low, especially because there is no cost of living adjustment mechanism as in the other ERISA contribution and deduction limitation rules.³¹

The proposed Tax Reform Act of 1975³² contained several measures aimed directly at the "active participant" limitation problem. In order to provide horizontal equality for persons who cannot establish IRAs and make tax deductible contributions thereto because of their "active participation" in an employer's qualified plan (which plan often provides benefits less than the potential IRA benefits), the proposals make two major changes in the existing law: (1) active participants in qualified plans or Code section 403(b) annuity contracts (but not governmental plans) may make contributions to an IRA for themselves; and (2) an active participant in a qualified plan (other than a governmental plan) which was in existence on September 2, 1974, is to be permitted

30. CODE § 219(b)(2).

31. Pursuant to CODE section 415(d), the Secretary of the Treasury may adjust annually the defined benefit plan \$75,000 retirement benefit limitation (§ 415(b)) and the \$25,000 defined contribution plan contribution limitation (§ 415(c)) for increases in the cost of living.

32. HOUSE COMM. ON WAYS AND MEANS, TAX REFORM ACT OF 1975, H.R. Doc. No. 10612, 93d Cong., 2d Sess. (1973). These provisions were not part of the "tax reform" package signed by President Ford in December of 1975, but are expected to be considered again by the House and Senate during the early part of 1976.

to make a tax deductible contribution to that plan if the plan so provides. The IRA deduction limitations continue to apply, but they are further reduced by the amount of employer contributions to the qualified plan allocable to the employee. As with the administration's proposals, the object is to provide each employee, regardless of whether he is a participant in a qualified plan, the opportunity to make tax deductible contributions to a retirement plan to the extent that the tax deductible amount is not being contributed to a plan for him by an employer.

These ideas are logical and seem likely to become law eventually. However, we must live with the present limitation until that time. Proposed Treasury regulations issued in early 1975 shed some light on the "active participant" question:

For purposes of this section the term "active participant" means . . . an individual who is a participant in a [qualified plan] and for whom, at any time during the taxable year,

- (1) Benefits are accrued under the plan on his behalf,
- (2) The employer is obligated to contribute to or under the plan on his behalf, or
- (3) The employer would have been obligated to contribute to or under the plan on his behalf if any contributions were made to or under the plan.³³

An "active participant" is also described in the negative as follows:

For purposes of this section, an individual is not an active participant under a plan—

- (1) With respect to any prior taxable year of such individual, merely because he is given past service credit for prior years of service;
- (2) With respect to any taxable year of such individual beginning after his separation from service covered under the plan and before he resumes service covered under the plan, whether or not he has a non-forfeitable right to benefits under such plan; or
- (3) For any taxable year of such individual in which such individual does not elect under the plan to participate in such plan.³⁴

Hopefully, the final regulations, when promulgated, will clarify the issue further. In addition to these interpretative questions, there has been some question whether or not an employee can request termination of

33. Proposed Treas. Reg. § 1.219-1(c)(1)(ii)(A), 40 Fed. Reg. 7662 (1975).

34. Proposed Treas. Reg. § 1.219-1(c)(1)(ii)(B), 40 Fed. Reg. 7663 (1975).

his participation in a noncontributory pension or profit sharing plan in order to establish his own IRA. Strict construction would indicate that, unless a plan provides that an individual may elect not to participate, a plan or indirectly an employer, may foreclose a participant's use of an IRA by making contributions on his behalf. Language in the IRA tax reform proposals implies that the alternative use of an IRA after terminating qualified plan participation is possible, since this is one of the occurrences which is prompting the reform proposals.

Refusing participation in a qualified corporate or Keogh plan may be a viable alternative for the employee who does not receive employer contributions to a qualified plan in amounts equal to or greater than what he could contribute to an IRA for himself. Due to the advantages of maintaining retirement funds in a qualified retirement plan versus an IRA, and the slippery tax benefit derived from IRA deductions in relation to the tax-deferred compensation which the employer contributes to the qualified plan on behalf of the individual, the economic and legal wisdom of such a change is questionable.

No deduction is allowed for contributions to IRAs which, although otherwise qualified, are made during or after the taxable year in which the contributor attains age 70½.³⁵ This provision is consistent with the mandatory distribution rule referred to above, and both clauses represent a substantial limitation on the use of IRAs. As will be seen later, no deduction is allowed for roll-over contributions;³⁶ this is, of course, a necessary rule and logically fits the roll-over scheme. While the deduction limitation is based upon 15 percent of compensation, the term "compensation" means "earned income" as defined in the Code.³⁷ One ostensible plus in the IRA legislation is that the maximum deduction limitation is computed separately for each spouse, without regard to any community property laws.³⁸ This allows a potential annual retirement savings of \$3,000 for a husband and wife if all other conditions are met.

GENERAL TAX TREATMENT OF IRAS

Unless an IRA loses its qualified status, as described below, it is generally exempt from all taxation under the Internal Revenue Code.³⁹

35. CODE § 219(b)(3).

36. CODE § 219(b)(4).

37. CODE § 219(c)(1); earned income is defined in CODE § 401(c)(2).

38. CODE § 219(c)(2).

39. CODE § 408(e)(1).

However, notwithstanding that an IRA is in compliance with the applicable rules and regulations, the unrelated business income of an IRA is taxable.⁴⁰

If the owner of an IRA (or his beneficiary) engages in the conduct of a prohibited transaction with respect to the IRA, then as of the first day of such individual's taxable year in which the transaction occurs, the IRA loses its qualified status;⁴¹ this occurrence has many negative ramifications and should be guarded against. Prohibited transactions are defined in section 4975 of the Code,⁴² and generally, include "self-dealing" transactions between the IRA and "related" parties, where an arms-length transaction is not likely to occur. However, due to the nature of IRAs and the circumstances under which they will be established, prohibited transactions will probably not be common occurrences in the IRA context. Nevertheless, all persons dealing with an IRA to any extent should be aware of the prohibited transaction rules and the "disqualification" results. One aspect of the disclosures required by the IRS with respect to the establishment of an IRA deals with informing the individual of the prohibited transaction rules.⁴³

If an IRA is disqualified, a constructive distribution occurs, and the individual is treated as having received, on the first day of his taxable year in which the disqualification occurs, an amount equal to the fair market value of all the assets in the account;⁴⁴ the distribution is ordinary income includable in the gross income of the distributee.⁴⁵ In addition, unless the distributee is 59½ years old or disabled on the day of the constructive distribution, a 10 percent penalty tax is imposed

40 *Id.*; see CODE § 511 and the related regulations.

41. CODE § 408(e)(2).

42. CODE § 4975(c) defines the term "prohibited transaction" as any direct or indirect

(A) sale or exchange, or leasing, of any property between a plan and a disqualified person;

(B) lending of money or other extension of credit between a plan and a disqualified person;

(C) furnishing of goods, services, or facilities between a plan and a disqualified person;

(D) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan;

(E) act by a disqualified person who is a fiduciary whereby he deals with the income or assets of a plan in his own interest or for his own account; or

(F) receipt of any consideration for his own personal account by any disqualified person who is a fiduciary from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.

43. See notes 116-24 *infra* and accompanying text.

44. CODE § 408(e)(2)(B).

45. CODE § 408(d)(1).

based upon the fair market value of the constructive distribution.⁴⁶ If a disqualification occurs, all of the income for the taxable year of the constructive distribution will be taxable to the trust.⁴⁷ If an IRA is disqualified because of the prohibited transaction rules, then the prohibited transaction penalty taxes, which may be as high as 100 percent of the amount involved in the transaction, are inapplicable.⁴⁸

An individual may cause the same constructive distribution and penalty tax treatment if he "borrows any money under or by use of such [an annuity] contract", if he maintains an individual retirement annuity,⁴⁹ or if he pledges his IRA as security for a loan.⁵⁰ This requirement, of course, prohibits the attractive and common practice of borrowing from the issuer and using the annuity contract as security.

PRACTICALITIES IN ESTABLISHING AN IRA

To accommodate people who wish to establish an individual retirement account, the IRS has prepared and made available model trusts and custodial account agreements.⁵¹ These forms make it very simple for banks and savings and loan associations to establish IRAs for qualified individuals. The model forms constitute agreements between the individual depositor and the trustee or custodian, and when properly executed and followed, contributions made pursuant to the agreement will be deductible. Individually drafted and designed forms may be used, but since the flexibility is limited with respect to the establishment and use of an IRA, most situations will be well suited for the IRS form; indeed, until the final regulations are issued, the only "safe harbor" may be to use the IRS form.

None of the model trust or account forms are to be filed with the IRS. However, IRS Form 5329⁵² must be filed with Form 1040 by each person who has established an individual retirement savings plan. Form 5329 must be filed by any individual on whose behalf an IRA has been established, regardless of whether the IRA was set up by the individual, his employer, or an employee association. Each person who established an IRA during his 1975 tax year should have received an

46. CODE § 408(f)(2).

47. CODE § 408(e)(1).

48. CODE § 4975(c)(3).

49. CODE § 408(e)(3).

50. CODE § 408(e)(4).

51. IRS Form 5305, Individual Retirement Trust Account; IRS Form 5305-A, Individual Retirement Custodial Account.

52. Return for Individual Retirement Savings Arrangement.

information statement from the issuer of the individual retirement arrangement, (*i.e.*, a bank, insurance company, etc.) prior to January 31, 1976.⁵³ Form 5498, which is analagous to the W-2 form for reporting wages, must be filed with the Form 5329 IRA tax return form. Unfortunately, this adds to the individual taxpayers' administrative burden by requiring all taxpayers who have IRAs to file Form 5329 including those who would not otherwise have to file Form 1040. In addition, taxpayers who ordinarily may be eligible to file Form 1040A are barred from doing so if they claim an IRA deduction; they will now be required to file Form 1040 together with Form 5329 required to support the IRA deduction. Consistent with the philosophy of the entire internal revenue system, there are provisions in the form for self-assessment of penalty taxes due to premature distributions from and excess contributions to an IRA.⁵⁴

Currently, the commercial departments of many banks and savings and loan associations are soliciting funds for investment in prototype individual retirement accounts. Sponsors of these prototype plans are required to file IRA Form 5306 with their written IRA agreement.⁵⁵ Initially, the investment of most of these IRA funds will probably be limited to the various savings devices offered by that particular bank. The trust departments of the various banks will also get into the act as custodians and trustees of the IRA funds, especially roll-over accounts, with consequent increased investment flexibility and greater administrative costs. IRA funds may generally be invested in any investment that is permitted for qualified corporate retirement plans, including stocks, bonds, mutual funds, real estate, commercial paper, savings accounts, etc. However, investing in life insurance is prohibited for an IRA.⁵⁶ To facilitate the management of IRA funds by bank trust departments, the Code allows commingling of funds with common trust funds or common investment funds, but not otherwise.⁵⁷

Purchase of an IRA annuity or endowment contract which satisfies Code section 408(b) may be made from numerous insurance companies. An alternative for a "qualified" individual retirement savings plan is the purchase of a "retirement bond" issued under the aegis of Code section 409; these retirement bonds may be purchased in denomina-

53. IRS Form 5498, Statement of Account for Participants in Individual Retirement Accounts or Annuities, IRS Announcement 75-106, October 20, 1975.

54. IRS Form 5329, parts IV and V.

55. IRS Form 5306.

56. CODE § 408(a)(3).

57. CODE § 408(a)(5).

tions of \$50, \$100, and \$500 at Federal Reserve Bank branch offices. They pay interest at a rate of 6 percent compounded semiannually, and are redeemable at age 59½ and upon retirement or disability. Although the 6 percent interest is not as attractive as the 7½ percent rate obtainable at many banks and savings and loan associations, the rate is guaranteed until retirement. The fixed rate, of course, may or may not turn out to be advantageous, depending upon future interest rates.

The federal banking regulatory authorities have responded positively to the IRA legislation by modifying some of the rules relating to maximum interest payable, minimum deposits, and withdrawal penalties for IRAs. To facilitate the offering of IRAs by member institutions the Federal Reserve Board and the Federal Home Loan Bank Board have amended their regulations to permit payment of all or a portion of an IRA time deposit in accordance with the payout terms of the IRA agreement prior to maturity without imposing the usual interest penalty when the owner of the account attains age 59½ or becomes disabled.⁵⁸ In addition, member institutions are now authorized to waive the \$1,000 minimum denomination requirement for time deposits with four and six year maturities at ceiling rates of 7¼ and 7½ percent when such deposits are made pursuant to IRA contracts.⁵⁹ An examination of the question of whether elimination of the 1/4 percent differential in interest rate ceilings for time deposits that now prevails between commercial banks and thrift institutions is appropriate in the case of long-term IRAs is being conducted by the Federal Reserve Board. Other changes which encourage the establishment of IRAs and simultaneously enhance horizontal income tax equality may be expected.

EMPLOYER-SPONSORED IRAS

An employer may create a domestic trust for the exclusive benefit of his employees or their beneficiaries.⁶⁰ If the trust meets all the "individually-sponsored" IRA rules contained in ERISA,⁶¹ and in addition, there is a provision requiring a separate accounting for the interest of each employee,⁶² then the trust will be treated as an IRA for all

58. 40 Fed. Reg. 57663 (1975); see Federal Home Loan Bank Board regulations at 40 Fed. Reg. 57664 (1975).

59. See note 58 *supra*.

60. The trustee of such a trust is limited to those entities and/or persons mentioned in the text accompanying notes 8-13 *supra*.

61. CODE § 408(c)(1); see CODE §§ 408(a)(1)-(7).

62. CODE § 408(c)(2).

purposes. Similar to an employer's qualified corporate retirement plan, the assets of the trust may be held in a common trust fund, common investment fund, or common fund for the account of all individuals who have an interest in the trust.⁶³ An association of employees (any organization composed of two or more employees) may also create a trust for its members which will be treated as an IRA if the above requirements are met.⁶⁴

The IRS has released Form 5304.⁶⁵ This relatively simple, one-page form may be used by employers, labor unions or other employee associations who desire advance IRS approval of a trust to be used for IRAs.

The discrimination-in-coverage problem that is always present with regard to qualified corporate plans is not an obstacle to the establishment of employer-sponsored IRAs, since any employee not covered under an employer-sponsored trust could establish his own individual retirement savings account. However, coverage requirements with respect to a qualified corporate plan cannot be satisfied by the rationale that those not covered by the corporate plan may be covered by an IRA. Contributions made by an employer to an IRA established for his employees constitute the payment of compensation to the employee includable in his gross income.⁶⁶ Such contributed amounts are subject to FICA and FUTA taxes, but there is no requirement to withhold federal income taxes if the employee will receive an IRA deduction for the contribution.⁶⁷

Thus, there is a considerable difference between the treatment of employer contributions to a qualified corporate plan, and employer contributions to an employer-sponsored IRA: In the first instance, the employer gets the income tax deduction for the contribution, the employee is not immediately taxed on the contribution made on his behalf, the employee receives no income tax deduction for such contribution, and the employer does not pay FICA or FUTA taxes on the contributions; with the IRA, the employer is entitled to an income tax

63. CODE § 408(c); Proposed Treas. Reg. § 1.408-2(c)(4), 40 Fed. Reg. 7669 (1975).

64. CODE § 408(c); Proposed Treas. Reg. § 1.408-2(c)(4)(ii). 40 Fed. Reg. 7669 (1975).

65. Application for Determination Individual Retirement Account.

66. CODE § 219(a).

67. JOINT EXPLANATORY STATEMENT OF THE COMMITTEE OF CONFERENCE, SECTION VII, H.R. CONF. REP. NO. 1280, 93d Cong., 2d Sess. (1973), 3 U.S. CODE CONG. & AD. NEWS 5113 (1974).

deduction, the employee is taxed as compensation on the amounts contributed on his behalf, and he gets a corresponding income tax deduction therefor, and the employer is subject to the FICA and FUTA tax liability on IRA contributions. In both cases, amounts contributed on behalf of an employee are counted in determining the employee's reasonable compensation level.

THE ROLL-OVER CONCEPT

Pension portability was one of the main concepts which Congress considered when the IRA provisions were drafted. Limited transferability of funds without taxation formerly was possible in certain circumstances. Prior law required, except with respect to the transfer of an employee's account balance from a corporate or Keogh qualified plan to a qualified plan of a successor corporation or unincorporated business, that the total distributions from a qualified plan, payable to an employee upon separation from service, be included in the income of the employee in the year of the distribution. With the exception of these pre-ERISA roll-overs, all distributions were taxed on the theory of actual or constructive receipt.⁶⁸ Labor mobility, greater equality of treatment regarding retirement programs for the labor force, and a strengthened, more attractive private retirement system were some of the objectives behind the portability provisions.

When considering initial drafts of ERISA, the Committee on Finance of the United States Senate proposed, as a portability device, the establishment of a central portability fund administered by the newly established Pension Benefit Guaranty Corporation. The Senate report contemplated that

when an employee leaves an employer who has registered with the central fund, he may direct the employer's qualified plan to pay the value of his entire vested benefits to the central fund. (Alternatively, if an employer makes a final distribution to an employee, as explained below, the employee can contribute this amount to the central portability fund without tax consequences.) Thereafter, the employee may leave his account in the central fund until his retirement or may have the fund transfer his account to the qualified trust of a new employer (who has registered with the fund and consents to the transfer). The central fund will invest its assets, and income earned will be allocated to the participants' accounts. However, this income will not be taxed until it is

68. CODE § 72(h).

distributed to the participants or their beneficiaries. Transfers between the fund and qualified plans will be tax free.⁶⁹

Substantially the same result will be accomplished by the final version of ERISA dealing with the portability concept, but the method used will be radically different; in addition, IRAs will cause minimal government interference and participation compared with the central portability fund.

Basically, the roll-over provisions allow eligible individuals to transfer certain funds between and among qualified corporate and Keogh retirement plans and IRAs without the incident of immediate taxation.

INTER-IRA ROLL-OVERS

ERISA provides, as one type of flexibility, that the funding medium of an individual retirement savings plan may be changed without adverse income tax consequences.⁷⁰ An individual may take a distribution (in cash or in kind) of all or part of the assets in his IRA, and if the total amount distributed (in cash and in kind) is reinvested in another type of individual retirement savings plan within sixty days after the distribution, then there will be no income tax effect because of the transaction.⁷¹ Similarly, amounts may be transferred between IRAs, individual retirement annuities and qualified retirement bonds with the same favorable treatment.⁷² The diversification of an individual's retirement savings plan is also made possible by these roll-over provisions since there is no requirement that the entire amount in an IRA, individual retirement annuity, or qualified retirement bond be distributed and subsequently reinvested; with respect to this type of roll-over, it is possible to withdraw and reinvest to any extent desired. However, the Code does limit the frequency of this type of roll-over to only once in every three years.⁷³

The roll-over concept which seems to be the most exciting from a tax-planning standpoint is that of transferring funds tax-free between corporate or Keogh qualified plans and IRAs. Roll-overs "into" an IRA are subject to different rules and limitations than roll-overs "out" of

69. SENATE COMM. ON FINANCE, S. REP. NO. 383, 93d Cong., 2d Sess. (1973), 3 U.S. CODE CONG. & AD. NEWS 4957 (1974).

70. CODE § 408(d)(3)(A)(i).

71. CODE §§ 408(d)(3)(A)(i), 408(d)(1).

72. CODE §§ 408(d)(1), 409(b)(3)(C).

73. CODE § 408(d)(3)(B); Proposed Treas. Reg. § 1.408-1(b)(2)(iii), 40 Fed. Reg. 7666 (1975).

an IRA. A transfer of funds directly to a successor employer's plan is subject to some unique limitations as well. These various transfers must not only be executed with precision as to time and amount, but there are problems connected with the management of funds temporarily held in an IRA.

ROLL-OVERS INTO AN IRA

Roll-overs into an IRA from a corporate or Keogh qualified retirement plan (from an employee's trust described in section 401(a) which is exempt from tax under section 501 (a)) may be accomplished tax-free if certain guidelines are followed.⁷⁴ If a "lump sum distribution"⁷⁵ is paid to an employee-participant of a qualified plan, and if such employee transfers the total distribution into an IRA, individual retirement annuity, or qualified retirement bond no later than sixty days after he receives the distribution, then the total of such distributions shall not be includible in the employee's gross income for the year of the distribution.⁷⁶ At this time the law seems to require that the distribution from the qualified plan be paid into a single IRA to qualify.

Several caveats are in order, however. Only if the IRA roll-over account retains its "roll-over" character 100 percent (*i.e.*, if there are no funds in the account except those attributable to the roll-over contribution) can the account then be subsequently rolled over into the qualified plan of a successor employer.⁷⁷ Thus, a "non-roll-over" contribution to a conduit IRA will foreclose any roll-overs to qualified corporate or Keogh plans; however, a roll-over to another IRA is still feasible. If the lump sum distribution is received by an "employee"⁷⁸ (a partner or other self-employed participant in a Keogh plan) at a time when contributions were made on his behalf under a Keogh plan, then the distribution may not be subsequently rolled over into a successor employer's qualified corporate or Keogh plan, or a qualified annuity plan;⁷⁹ however, roll-over into another IRA is permissible in this instance.⁸⁰

The lump sum distribution must be stripped of those amounts "considered contributed by the employee"⁸¹ and "the net unrealized

74. CODE § 402(a)(5).

75. CODE § 402(e)(4)(A).

76. CODE § 402(a)(5).

77. CODE § 408(d)(3)(A)(ii).

78. CODE § 401(c)(1).

79. CODE §§ 402(a)(5), 403(a)(4).

80. CODE § 408(d)(3)(A)(i).

81. CODE § 402(e)(4)(d)(i).

appreciation attributable to that part of the distribution which consists of the securities of the employer corporation"⁸² in order to receive roll-over treatment on this and subsequent distributions.⁸³ This result obtains because of the zero basis rules for IRA funds. If employee contributions must be withdrawn from a distribution, then, to the extent possible, they will come out of the cash element of the distribution, and if necessary, out of the fair market value of the "in kind" element.⁸⁴ With this exception, all property received in a lump sum distribution must be rolled over "in kind."⁸⁵ Roll-overs between IRAs and qualified trusts and vice versa are not subject to the three year limitation; they may be accomplished whenever desired or possible under the lump sum distribution rules.⁸⁶

LUMP SUM DISTRIBUTIONS

As stated above, only lump sum distributions will qualify as "roll-over amounts" and thus be eligible for preferential tax treatment.⁸⁷ For roll-over purposes, a lump sum distribution is defined as

the distribution or payment within one taxable year of the recipient 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 59½,
- (iii) on account of the employee's separation from the service, or
- (iv) if the employee becomes disabled (within the meaning of section 72(m) (7))⁸⁸

A lump sum distribution can only be made from a qualified corporate or Keogh plan trust or a qualified annuity plan.⁸⁹ Clause (iii) above is applicable only to common law employees, while the "disability" contingency in clause (iv) is applicable only to self-employed persons.⁹⁰ Formerly, lump sum distribution treatment was available at age 59½

82. CODE § 402(e)(4)(d)(ii).

83. CODE § 402(a)(5)(B).

84. CODE §§ 402(a)(5)(C), 403(a)(4)(C).

85. CODE §§ 402(a)(5)(C), 403(a)(4)(C), 408(d)(3).

86. CODE § 408(d)(3)(B).

87. CODE §§ 402(a)(5)(A), 403(a)(4)(A). To qualify for roll-over treatment "the balance to the credit of an employee [must be] paid to him on one or more distributions which constitute a lump sum distribution within the meaning of section 402(e)(4)(A) determined without reference to section 402(e)(4)(B)" CODE § 403(a)(4)(A).

88. CODE § 402(e)(4)(A).

89. CODE § 402(a)(4)(A).

90. *Id.*

only to self-employed participants; this limitation is no longer valid. Common law employees may now receive a lump sum distribution after age 59½. An annuity contract may be distributed and receive lump sum distribution classification, and a distribution to two or more trusts may receive lump sum treatment.⁹¹ Presumably, the trust distribution provision will allow roll-over into multiple IRAs or qualified plans, assuming other requirements are met.

The elective lump sum distribution provision of Code section 402(e)(4)(B) should not be confused with the lump sum roll-over concept. Electing lump sum distribution treatment with respect to a distribution has the effect, for one not rolling the amount over, of activating some of the new rules for taxing lump sum distribution; these rules are an alternative to roll-over treatment.⁹²

For purposes of determining "the balance to the credit of an employee," all qualified plans of the same type maintained by an employer must be treated as a single plan.⁹³ This provision will not affect many employees, but in a case where an employer maintains both a defined benefit and a defined contribution pension plan, for example, the lump sum distribution must include all of the employees' accounts in both plans.

It is apparent from the definition of a lump sum distribution that ERISA prohibits lump sum distribution classification (and thus roll-over treatment) for participants under age 59½ unless the distribution is payable because of the separation from service of a common law employee or the disability of a self-employed participant. Thus, lump sum distribution treatment in the roll-over context is not available with regard to plan terminating distributions, and the question of why the distribution becomes payable remains crucial.⁹⁴ The Tax Reform Act of 1975⁹⁵ contained a proposal that would make eligible for tax-free roll-over treatment (*i.e.*, lump sum classification) distributions of the

91. *Id.*

92. CODE § 402(a)(4)B.

93. CODE § 402(e)(4)(C)(i).

94. In this regard, there seems to be an inconsistency between the statutory language itself, which clearly allows the lump sum treatment for distributions after age 59½ even if there is no separation from service, and the report of the House Committee on Ways and Means which accompanied the House version of ERISA (H.R. 12855) and stated that a distribution would have to occur because of an employee's separation from service if lump sum treatment was to follow. H.R. REP. No. 809, 93d Congress, 2d Sess. 140 (1973).

95. HOUSE COMM. ON WAYS AND MEANS, TAX REFORM ACT OF 1975, H.R. DOC. No. 10612, 93d Cong., 2d Sess. (1973).

balance to the credit of an employee under a qualified plan which is paid to the employee within one taxable year, on account of the termination of the plan or the complete discontinuance of contributions under the plan. This rule was to be retroactively applicable to distributions after July 4, 1974. The provision is actually an attempt to correct an oversight in the ERISA IRA provisions, and should be enacted into law during 1976. As an alternative to an attempt to treat a distribution as a roll-over when a plan termination is foreseen, a merger of the two qualified plans, or a transfer of funds directly between the trustees should be explored. A nonqualifying distribution not only forecloses the possibility of utilizing the roll-over concept, but unfavorable income tax consequences result.⁹⁶

One disturbing section of the lump sum definitional provision concerns the requirement in Code section 402(e)(4)(H) that "no amount distributed to an employee from or under a plan may be treated as a lump sum distributed under [the lump sum distribution definition] unless he has been a participant in the plan for 5 or more taxable years before the taxable year in which such amounts are distributed." The utility of the lump sum distribution roll-over provisions is decreased if this provision is interpreted to mean that five years of participation is required in any plan in order to be eligible for lump sum distribution and roll-over treatment. One commentator logically suggests that this provision seems to be only a requirement for the utilization of ten year forward income averaging with respect to the tax on lump sum distributions.⁹⁷ Since the provision does not apply to the capital gains element of a distribution, and was transferred to this context from a logical, parallel provision in section 72, this suggestion seems correct.⁹⁸ In addition, language in the provision appears to limit its application to subsection 402(e),⁹⁹ so that sections 402(a), 403(a) and 408(d) are left beyond its scope.¹⁰⁰

Questions regarding the valuation of IRA funds were apparently not addressed by the new Code provisions or the regulations. For instance, when stripping a distribution of employee contributions for roll-over into an IRA, are the funds valued on distribution or recontribu-

96. A lump sum distribution is a prerequisite for capital gain or ten year forward income averaging treatment. CODE § 402(e).

97. Colby, *Scope of Rollover Provisions in New Law for Lump-Sum Distributions*, 43 J. TAX. 7 (1975).

98. See CODE § 72(n)(1)(C) where five years of participation was required for five year averaging treatment of a distribution.

99. Tax on Lump Sum Distributions.

100. See note 94 *supra*.

tion? Also, there are unanswered questions regarding the disposition of interim earnings. Definitive regulations should be issued to resolve these interpretive questions.

CONDUIT IRAS

Recipients of lump sum distributions from qualified plans may wish to park their funds in an IRA temporarily. Obviously this is one of the intended uses of the IRA, because upon receipt of a lump sum distribution, an employee may not be able to roll his funds into the qualified plan of his new employer within the sixty day limitation period. There may be a participation-eligibility waiting period; the plan may not accept roll-over contributions from an employee; the trustee may be able to accept only certain assets (*i.e.*, cash or some other prudent investment); or the assurances required by the new trustee that the employee is transferring a qualified roll-over may take additional time.

A roll-over into an IRA for a self-employed Keogh plan participant is not a sensible move in most cases since Code section 408(d)(3)(ii) provides that contributions from such sources are taxable as ordinary income when distributed from the IRA, and are not eligible for roll-over treatment. Also, the category of distributions received by a "self-employed individual" eligible for lump sum treatment is limited. As stated previously,¹⁰¹ a separation from service alone is not enough to qualify a distribution as a lump sum. Only distributions made subsequent to the self-employed Keogh plan participant's attainment of age 59 1/2, death or disability will qualify as lump sums, and thus be eligible for tax-free treatment when rolled over into an IRA.

However, it is possible for common law employee-participants of Keogh plans to use the IRA favorably as a conduit, provided that all the other limitations in Code section 408(d)(3) are met. With the common law employee Keogh plan participant, a mere separation from the service of the employer will generate a lump sum distribution. Transferring the funds tax-free out of the IRA into another qualified plan is possible for the common law employee also, if all the other requirements of Code section 408(d)(3) are met.

When a lump sum distribution is placed in an IRA from a qualified plan, several problems arise. Whereas distributions from a qualified trust are subject to favorable rules regarding taxation, a distribution from the IRA, if not a roll-over distribution, will be taxed as ordinary

101. See note 88 *supra* and accompanying text.

income.¹⁰² Thus, there is a risk that an event requiring distribution (*i.e.*, death or disability) may occur while the funds are "temporarily" being held in the IRA. Assuming a subsequent roll-over into a qualified plan is accomplished, then the five year participation requirement referred to above will have to be met before the employee will be eligible for lump sum distribution treatment, with regard to the possible use of ten year forward income averaging, from the qualified plan.¹⁰³ One of the big advantages for a distribution out of a qualified plan is the estate tax exclusion for amounts attributable to employer contributions.¹⁰⁴ This exclusion vanishes when the funds are rolled over into an IRA; a subsequent roll-over into another qualified plan will restore the advantage, unless the IRS makes the unreasonable interpretation that an employee's roll-over contribution of funds derived from a prior employer's contributions lose their character and become employee contributions ineligible for the Code section 2039(c) estate tax exclusion.

If it appears that a distribution may become permanently trapped in an IRA, or if a distribution is transferred into an IRA without the prospect of a subsequent roll-over into a qualified plan, then the possibility exists that a somewhat more favorable tax treatment remains available because of the installment payout or annuity options, whereby the income taxation of the distributions would be spread over many years when the payee is probably in a relatively more favorable tax bracket. It has been suggested that if one finds himself with a lump sum distribution trapped in an IRA, that one possible way out would be the creation of a 100 percent owned corporation and a subsequent roll-over to the qualified plan created for that corporation.¹⁰⁵ One might

102. CODE § 408(d)(1).

103. CODE § 402(e)(4)(H) requires five years of participation before a participant will be eligible for lump sum distribution treatment and utilization of ten year forward income averaging and/or capital gain treatment. However, the IRS may decide to allow tacking of participation periods.

104. CODE § 2039(c).

105. "The new business might not even have to be incorporated since lump sum distributions from H.R.-10 plans are now taxed essentially in the same manner as those from corporate plans." Colby, *Scope of Rollover Provisions in New Law for Lump-Sum Distributions*, 43 J. TAX. 7, 9 (1975).

Some have expressed the view that the requirements in Section 408(d)(3)(A)(ii) that amounts distributed from a qualified plan and passed through a conduit IRA must be "paid into another such trust" means that the successor employer's plan cannot be one in which the individual would be an employee within the meaning of Section 401(c)(1). This is because the immediately preceding language describing the trust from which the sums were originally distributed excludes a trust in which the distributee was a Section 401(c)(1) employee. This is not an unreasonable reading, but the language is certainly ambiguous and there would appear to be no policy reason for limiting rollovers from conduit IRAs only to qualified plans in which the individual is not a Sec-

rationalize that creation of a qualified plan solely for this purpose is not an abuse since there is apparently no legislative policy reason why lump sum distributions transferred into an IRA should be denied equal tax treatment, all other things being equal.

ROLL-OVERS TO QUALIFIED PLANS

Since use of an IRA as a conduit for roll-overs has many potential pitfalls, the direct tax-free transfer of funds between the qualified plan of the prior employer to the plan of a successor employer is a very attractive and feasible alternative, especially from the viewpoint of a prospective employee facing possible adverse income tax consequences relating to his termination of service. In order to accomplish such a roll-over, the plan of the successor employer must provide for the acceptance of roll-over contributions.¹⁰⁶ If there is no such provision and a roll-over is accepted, the plan may become disqualified because of excessive "non-roll-over" contributions, and the roll-over will not be tax-free.¹⁰⁷

To facilitate the disbursement of lump sum distributions to individuals from an IRA, and to ostensibly protect the trustee, the individual who is to receive the distribution must certify to the trustee in writing that the distribution is to be a roll-over contribution; in fact, a distribution may be made to one not 59½ years of age or disabled only upon this contingency.¹⁰⁸ Likewise, it is contemplated that IRA trustees who accept roll-overs will be required to obtain certifications of roll-over status for the contribution.¹⁰⁹ While there are as yet no formal rules with regard to whether the trustee of a qualified plan should require a "roll-over certification," practice in this context seems to dic-

tion 401(c)(1) employee. The provisions allowing direct rollovers from one qualified plan to another, Sections 402(a)(5) and 403(a)(4), do not allow the rollover of amounts attributable to plans under which the employee was a Section 401(c)(1) employee, but clearly do . . . allow rollovers to such plans. There would seem to be no reason to prevent accomplishing through a conduit IRA what could have been done directly.

Id. at 9 n.26.

106. Proposed Treas. Reg. § 1.402(a)-3(c)(2), 40 Fed. Reg. 18798 (1975).

107. A nonqualifying lump sum distribution rolled over into a qualified plan will be classified as an employee contribution and, if substantial in amount, may exceed the "annual addition" limitation of CODE § 415. CODE § 401(a)(16) denies qualification to a plan "which provides" for contributions in excess of the CODE § 415 limitation. While the trustee may be able to successfully argue that the plan did not provide for such an excess contribution, the problems generated by this transaction will be immense.

108. Proposed Treas. Reg. § 1.408-1(b)(2)(iv), 40 Fed. Reg. 7666 (1975).

109. H.R. REP. No. 807, 93d Cong., 2d Sess. 193 (1973), 3 U.S. CODE CONG. & AD. NEWS 4805 (1974).

tate extreme caution. However, disqualification of a plan that has inadvertently accepted a contribution which does not qualify for lump sum treatment will not be automatic. With such potential problems in mind, trusts that are to possess the capacity to receive a lump sum roll-over distribution should not only protect the trustee by requiring some evidence that the contribution does qualify as a roll-over, but separate, segregated accounts should be maintained for all roll-over contributions.

Since in kind distributions must generally be rolled-over in kind, several problems arise. Securities of the employer corporation receive favorable tax treatment upon a distribution from a qualified plan.¹¹⁰ However, this tax advantage is lost when securities of the employer corporation are rolled over into either a successor corporation's qualified plan or an IRA.¹¹¹ If a successor plan trustee will not accept employer securities from the prior plan, a conduit IRA may be used to liquidate the distribution and then roll it over into the successor plan. Employer securities present an even more perplexing problem for in kind roll-overs because of the investment standards which the trustee of the successor plan must adhere to. While the employer securities may have been "qualifying employer securities" in the prior trust, they will not meet that classification when rolled over, thus possibly violating the prudence or diversification requirements of the successor plan and trust.¹¹²

As stated previously, unless regulations allow tacking of participation periods, an employee rolling over a lump sum distribution from a successor employer's plan to the plan of a new employer must wait at least until he has participated in the new plan for five years before he will be able to utilize the ten year forward income averaging provisions.¹¹³ However, such amounts once rolled over still remain eligible for the regular five year averaging rules of Code section 1301 upon subsequent distribution to the individual. Plan participants with significant account balances attributable to pre-1973 service may lose the potential capital gain treatment available for these amounts under Code

110. See CODE §§ 402(e)(4)(D)(ii), 402(e)(4)(J).

111. Employer securities rolled over into the qualified plan of a successor employer would not qualify as "employer securities" upon a subsequent distribution, and thus the CODE § 402(e)(4)(J) exclusions would not be applicable. A roll-over of employer securities into an IRA presents much the same problem in that CODE § 408(d) provides for a zero basis in all IRA funds, and all distributions, with the exception of annuities and roll-overs, will be taxed as ordinary income.

112. Employee Retirement Income Security Act of 1974, § 404(a)(2), 1 U.S. CODE CONG. & AD. NEWS 994 (1974).

113. CODE § 402(e).

sections 402(a)(2) and 403(a)(2) if they roll a lump sum distribution over into another qualified plan. This sterilization may occur because of the ERISA requirement that only amounts attributable to pre-1973 service are eligible for capital gain treatment under the Code, and since roll-overs were not generally permitted prior to ERISA, all participation in the successor plan will be post-1973; hopefully, the regulations will cure this apparent oversight.

A self-employed participant in a Keogh plan (an "employee" within the definition of Code section 401(c)(1)) generally may not utilize a roll-over as a means of transferring funds tax-free to the qualified plan of another employer, even if he meets all the lump sum distribution criteria.¹¹⁴ However, a common law employee-participant in a Keogh plan may take advantage of this type of roll-over if all the other tests are met.

The only feasible alternative for a self-employed person who wants to transfer his Keogh plan funds into the qualified plan of another employer involves proceeding under pre-ERISA law without an actual distribution to the self-employed. Revenue Ruling 71-541¹¹⁵ allows a roll-over to be effected without a current tax on the self-employed person if the transfer is between the respective plan trustees only. This type of transfer is especially attractive since it does not depend upon the existence of a lump sum distribution (*i.e.*, the self-employed can be under age 59½).

REPORTING AND DISCLOSURE

One of the functional areas of employee benefit plans "overkilled" by ERISA was the reporting and disclosure concept. ERISA will generate, after all of its provisions become fully applicable to all plans, a staggering amount of paperwork, a fraction of which is necessary or desirable. However, IRAs initially got off relatively light with regard to reporting and disclosure obligations.

The Department of Labor has decided that IRAs, individual retirement annuities and qualified retirement bonds will not be subject to the reporting and disclosure rules set forth in title I¹¹⁶ of ERISA.¹¹⁷ This exemption does not extend to employer-sponsored IRAs where the employer makes contributions to the IRA or where participation is

114. CODE § 402(a)(5).

115. 1971-2 CUM. BULL. 209.

116. Title I of ERISA contains the Department of Labor fiduciary responsibility and reporting and disclosure provisions.

117. Department of Labor Reg. § 2510.3-2(d), 40 Fed. Reg. 34525 (1975).

mandatory.¹¹⁸ However, employers may sponsor IRAs (possibly as an alternative to qualified corporate or Keogh plans), and if there are no employer contributions, participation by employees is voluntary, and the employer's involvement is minimal, then there are no title I Department of Labor reporting or disclosure obligations relative thereto. Employer-sponsored IRAs which do not meet these tests are subject to extensive reporting and disclosure regulations which parallel those for qualified plans.

Notwithstanding the Department of Labor disengagement from IRA regulation, the IRS has a multitude of reporting and disclosure responsibilities for individuals on whose behalf IRAs are maintained, issuers of individual retirement annuities, and trustees of IRAs. The proposed regulations require the trustees of IRAs or the issuer of individual retirement annuities to submit to the Commissioner and/or the individual on whose behalf the account is established, annual reports concerning the contribution to the account or annuity, the distributions if any, and various other items of information.¹¹⁹ For the most part, the IRS initially contemplated and required a reasonable reporting and disclosure system for IRAs; however, congressional and public agitation for more disclosure, both qualitatively and quantitatively, in connection with the establishment of IRAs forced the IRS to issue temporary regulations on the subject.¹²⁰ Disclosure statements in nontechnical language must be furnished to the individual on whose behalf the account is established seven days prior to the date upon which the account is established, or at the time of establishing the account if the transaction is revocable¹²¹ by the individual during the next seven days. The following information must be disclosed: (1) a concise explanation of the statutory requirements with respect to the account, annuity or contract, and the statutory limitations and restrictions on the retirement savings deduction; (2) a description of the prohibited transaction rules relative to the IRA, including the prohibitions against borrowing or pledging the account or security for a loan, the distribution guidelines, and certain accumulation regulations; (3) financial disclosures concern-

118. *Id.*

119. Proposed Treas. Reg. § 1.408-1(d)(1), 40 Fed. Reg. 7666 (1975).

120. Internal Revenue Service Temporary Regulations on Disclosure Statements for Individual Retirement Accounts, 40 Fed. Reg. 51635 (1975).

121. An individual will be considered to be "permitted to revoke" within the seven-day period only if he is entitled to a return of the entire amount of the consideration paid by him for the account, annuity, or contract, without adjustments for such items as sales commissions, administrative expenses or fluctuation in market value of the account. See IRS News Release IR-1533, December 1, 1975.

ing the account for various years where the projected growth of the funds can be illustrated using certain assumptions, any administrative or other changes which may be made against an account, contract or annuity, and the method for computing and allocating annual earnings.¹²²

Thus far, the approach of the IRS in this area has been reasonable, and has probably enhanced the attractiveness of most individual retirement savings plan arrangements because of increased levels of consumer understanding and protection. It was due to the IRS's initial reluctance (or tardiness) to impose extensive reporting and/or disclosure requirements on those owning, managing and sponsoring IRAs that some members of Congress forced the issue. Prior to the issuance of the temporary reporting and disclosure regulations, Representative Charles A. Vanik (D-Ohio), Chairman of the House Ways and Means Oversight Subcommittee urged the IRS to require IRA issuers, sponsors, custodians and trustees to disclose more to their customers with respect to the real and potential worth of an IRA, the levels of administrative costs involved, and a breakdown of administrative cost as compared to the net increase in the IRA's worth. Likewise, sales of individual retirement annuities and endowment contracts should be preceded by disclosure of front-end loads, clear interest earnings projected, clear interest earnings guaranteed, sums not allowed by ERISA as deductible and year-by-year growth of fund assets. As in any situation where selling of any commodity to the public is involved, there must be an adequate measure of protective disclosure; the temporary IRS regulations reflect these concepts.

The Federal Trade Commission recently announced that it would get into the act by conducting an industry-wide investigation of advertising and marketing of IRAs and individual retirement annuities to determine if any violations of the Federal Trade Commission Act are occurring.

In addition to the disclosures mentioned above, trustees and custodians of IRAs and insurance companies issuing individual retirement annuities must furnish participants with copies of Form 5498¹²³ in order to assist them in the preparation of their federal income tax forms.¹²⁴

122. 40 Fed. Reg. 51635 (1975).

123. See note 53 *supra* and accompanying text.

124. IRS Announcement 75-106, October 20, 1975. These forms should have been sent to the individuals prior to January 1, 1976. Form 5499 will be used by IRA trustees, custodians and insurance companies to transmit the Form 5498 information to the IRS by March 1, 1976.