Proposed Law Changes – House of Representatives

An article in the April newsletter summarized the IRA changes which would become law if the bill, as adopted by the House of Representatives, would be enacted into law. We have reformatted this article and have reproduced it as a special insert. The primary change would be to create a second type of IRA, the American Dream Savings Account. For simplicity reasons, we will call it the American Dream IRA™ (ADIRA™).

The purpose of this article is to summarize the non-IRA pension law changes as adopted by the House of Representatives on September 19, 1995. Another article summarizes the Senate’s proposal. As you probably know, President Clinton has said that he will veto the bill which comes from the Conference Committee unless there are some substantial changes. This article will give you a good idea of what law changes will most likely be made when and if a tax bill is ultimately signed into law. Most changes would be effective as of January 1, 1996.

1. The $5,000 death-benefit exclusion would be repealed. Why? This is a revenue-producing change. The IRS has wanted to eliminate this rule for the last five to ten years.

2. The ability to use five-year income averaging for lump-sum distributions would be repealed. Those QP participants who were age 50 as of January 1, 1986, would still be eligible to use ten-year averaging. Why? The fact that rollovers are now so readily available because of the changes made by the Unemployment Compensation Amendment of 1992 means that a person should be able to structure his or her distributions so that he or she does not need to take sizable distributions in any one tax year. One could also argue that such a change is made because one set of rules will apply to the pre-baby boomers and another set of rules will apply to the baby-boomers.

3. There would be a new simplified method of tax annuity payments.

4. The rules designed to prevent discrimination under a salary-reduction SEP plan will be “simplified.” Such SEPs will be able to be established by employers with 100 or fewer employees, rather than the current 25 employees. The requirement that at least 50% of the eligible employees must actually participate will be repealed. The maximum permitted actual deferral percentage for highly-compensated employees will be determined by reference to the prior year’s ADP of the non-highly-compensated employees. It will be possible for a salary-reduction SEP to meet a safe-harbor provision set forth in the plan document.

5. Nongovernmental tax-exempt entities (including Indian tribes) and state and local governments would be able to sponsor a 401(k) plan unless a section 457 plan is maintained. Under current law, such entities are not permitted to sponsor a 401(k) plan. Why the change? Money held in section 457 plans is now subject to the creditors of the governmental entity. As the incident in Orange County illustrates, governmental entities sometimes do go broke. Funds in a 401(k) plan are exempt from both the creditors of the employer (i.e. the governmental entity) and the creditors of any individual participant.

6. Similarly, all existing 457 plans, as adopted by a governmental entity, will need to be revised to state that all assets and income of such plan are held in trust (or custodial account or annuity contract) for the exclusive benefit of the participants and their beneficiaries. This provision is effective the later of: January 1, 1996 or 90 days after enactment.

7. There will be a “simplified” definition of who is a highly-compensated employee. An employee will be highly compensated with respect to a given year if the employee was (1) a five-percent owner of the employer at any time during the current year or the preceding year, or (2) had compensation for the preceding year in excess of $80,000 (as indexed). All other rules are repealed including the rule which required the highest paid officer to be considered highly-compensated even if he or she did not have the necessary income.

8. The rules requiring the compensations and elective deferrals of various family members be aggregated will be repealed.

9. The participation requirement of Code section 401(a)(26) will no longer apply to defined-contribution plans. It will continue to apply to defined-benefit plans.

10. The required minimum distribution rules would be essentially changed to be those rules which were in effect prior to the changes made by TRA 86. That is, a person who is a QP participant and who is not a five-percent owner and who does not retire at age 70 1/2, will have a required beginning date of April 1 of the year after he or she retires, and not April 1 of the year after attaining age 70 1/2. In addition, a defined-benefit plan will need to provide that such an employee’s accrued benefit will be actuarially increased for the time period during which the employee defers commencement of the accrued benefit.

11. The special aggregation rule of Code section 401(d) would be repealed. These rules apply to plans which cover owner-employees who are participants in certain plans maintained by an unincorporated sponsor.

12. Code section 415(e) contains a special limit if an employee participates in both a defined-benefit plan and a defined-contribution plan maintained by the same employer. This limit will be repealed. This is a monumental change and it will be a real boon for the very wealthy business customer. He or she will be able to maximize his or her defined contributions and then be able to have additional contributions made under a defined-benefit plan. This change will make defined-benefit plans very attractive.
1. 100% of the employee’s elective deferrals up to 3% of compensation, and
2. 50% of the employee’s elective deferrals from 3 to 5% of compensation; and
3. The level of match for highly-compensated employees cannot be greater than the match rate for nonhighly-compensated employees at any level of compensation.

Note that there will be a match of 4% by the employer if the employee defers at least 5% of his or her compensation.

The above rules will be deemed to have been met even if there is no compliance at some level of employee compensation if two special rules are met. First, the level of employer-matching contributions cannot increase as the employee elective contributions increase. Second, the aggregate amount of matching contributions with respect to elective deferrals up to that level of compensation must at least equal the amount of matching contributions that would be made if the above requirements had been met.

A plan will be treated as complying with the ACP rules if the plan meets the above-described ADP rules and the plan is not permitted to make matching contributions with respect to elective deferrals or employee contributions in excess of 6% of compensation. Second, the employer may not have the level of its matching contributions increase as the employee’s elective deferrals or the employee’s after-tax employee contributions increase.

Note that there will be separate ACP testing for matching contributions and after-tax employee contributions.

If either the ADP or the ACP test is not met, there will be a new rule with respect to the distribution of excess contributions to the highly-compensated employees. Under current law, the elective deferrals for highly-compensated employees are reduced in the order of their actual deferral percentage beginning with those who have the highest actual deferral percentage. The new rule will be that the excess contributions will be deemed attributable to those highly-compensated employees who made the greatest dollar amount of elective deferrals. The purpose and the consequence of this rule change is illustrated by the example in the Committee's report as set forth below.

16. The uniform penalty provisions which govern the preparation of IRS Forms 1099-int, 1099-div, etc. will be changed to include the preparation of the Form 1099-R, Form 5498 and the January IRA statement. Note that this change does cover IRAs. If enacted, this change would apply to any returns and statements with a due date after December 31, 1995. That is, it would apply to the 1995 forms required to be filed in 1996.
Proposed Law Changes – Senate

The Senate Finance Committee approved a tax package on October 19, 1995, which contained numerous IRA and pension law changes. The full Senate passed a tax bill on October 28, 1995. Next month's newsletter will discuss the Senate's proposals or the Conference Committee's bill in greater detail. This article presents a very brief summary of the Senate's proposed IRA changes along with a new type of pension plan.

There would be two types of IRAs — the traditional IRA which is often thought of as the “deductible” IRA, and a new type of IRA, “IRA Plus.” The IRA Plus is very similar in content to the House's American Dream Savings Account. There are some similarities in the Senate's proposed IRA changes along with the same rules as those which apply to “deductible” IRAs, but there are some additional rules. Obviously, the taxation of IRA Plus accounts would be different from that of the “deductible” IRA.

The main difference is that the Senate’s proposal would coordinate a contribution to the IRA Plus and the “deductible” IRA. The limit would be the lesser of 100% of compensation or $2,000. That is, a person could not contribute $2,000 to both types of accounts. For example, Mary Jones put $500 into an IRA Plus, then she would only be eligible to put $1,500 into a “deductible” IRA.

The most dramatic law change would be the gradual increase of the income limits which restrict the deductibility of IRA contributions when an IRA account holder or his or her spouse is an active participant in a pension plan. Under current law, a single person’s entitlement to a tax deduction is phased out over a scale of $10,000 when his or her gross income exceeds $25,000. Thus, a single person, who is an active participant, is not entitled to deduct any portion of his or her $2,000 IRA contribution when his or her adjusted gross income equals or exceeds $35,000. Under current law, a married couple’s entitlement to a tax deduction is phased out over a scale of $10,000 when their combined adjusted gross income exceeds $40,000. Thus, a couple, one of whom is an active participant, is not entitled to deduct any portion of their $4,000 IRA contributions when their adjusted gross income exceeds $50,000.

Commencing with 1996, these limits for a single person would increase at the rate of $5,000 per year so that for the year of 2007, the phaseout range would be $85,000 — $95,000. Note that the spread remains at $10,000 in the year 2007. For a married couple, the spread will change from $10,000 to $20,000. The new proposed schedules are set forth below.

Schedule Year for Singles Schedule Year for Marrieds
1995 $25,000 — $35,000 $40,000 — $50,000
1996 $30,000 — $40,000 $45,000 — $55,000
1997 $35,000 — $45,000 $50,000 — $60,000
1998 $40,000 — $50,000 $55,000 — $65,000
1999 $45,000 — $55,000 $60,000 — $70,000
2000 $50,000 — $60,000 $65,000 — $75,000
2001 $55,000 — $65,000 $70,000 — $80,000
2002 $60,000 — $70,000 $75,000 — $90,000
2003 $65,000 — $75,000 $80,000 — $100,000
2004 $70,000 — $80,000 $85,000 — $105,000
2005 $75,000 — $85,000 $90,000 — $110,000
2006 $80,000 — $90,000 $95,000 — $115,000
2007 $85,000 — $95,000 $100,000 — $120,000

The ability of more people to claim IRA deductions will certainly bring back to life IRA accounts as a source of deposit growth/service growth for financial institutions. To add to the popularity of IRAs, there will be new situations when the 10% excise tax will not be assessed, when the pre-59 1/2 distribution is on account of the purchase of a first home, the payment of certain educational expenses, etc. In fact, in the cases of certain qualifying adoption expenses, it is proposed the entire distribution will be excluded from income.

There are a number of other changes which will increase the demand for IRAs. First, under current law, a person who is married is considered to be an active participant if his or her spouse is an active participant. Under the new law, a person will not be disqualified from an IRA deduction just because his or her spouse is an active participant. Second, the spousal limit will be changed, in general, from $2,250 to $4,000.

As exciting as the new IRA rules are, the Senate proposes to authorize a new type of pension plan which also will be very exciting. The acronym for this new plan is SIMPLE — Savings Incentive Plan for Employees. The intent is to create a "simple" type of 401(k) plan. This plan would only be available to an employer who did not sponsor a retirement plan.

An employee under a SIMPLE plan would be allowed to make elective deferrals up to $6,000 per year and the employer would be required to make a 100% matching contribution up to 3% of compensation. All contributions made to a SIMPLE plan would be 100% vested.

Summary

The Senate, as the House of Representatives, has passed a tax bill which contains numerous IRA and pension law changes. New business opportunities will be presented by these law changes. Next month's newsletter will either discuss the Senate proposals in more detail, or will discuss the final rules as adopted by the Conference Committee.
Continued from page 3. The House—Representatives has passed a bill which changes only. However, one can reason­ably expect that if the President and the Republicans can reach a compromise, many of these proposals will become the law. Thus, the factor for 1995 will be 10.0, and for 1996 it will be 9.0. David’s single life expectancy factor in 1989 would have been 16.0. This factor is reduced for each elapsed year. Six years have elapsed before 1995 and seven years will have elapsed before 1996.

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17. New rules would be enacted to expand the protection or treatment of certain veterans under pension plans who leave employment for service and then return to work. For example, they would be given the right, within limits, to make retroactive 401(k) deferrals.

18. In certain situations, an employer would be allowed to move excess pension assets if done on or before December 31, 2000, and to use them for other business purposes. Such withdrawals would normally be included in the gross income of the employer. President Clinton has said that this provision or any similar provision will mean he will veto the bill within which such a provision is included.

Conclusion. The House of Representatives has passed a bill which would change many of the rules governing qualified plans, IRAs and other pension plans. These are proposed law changes only. However, one can reasonably expect that if the President and the Republicans can reach a compromise, many of these proposals will become the new law.

When Will Plan Documents Need to be Amended?

Plan documents will not need to be amended before the first day of the plan year beginning on or after January 1, 1997, if during the interim period the plan is operated in compliance with such new rules and such amendment applies retroactively to January 1, 1996, or such other day as is required by the new law.

A financial institution sponsoring prototypes will need to amend or update such prototypes in 1996 if the House’s proposals become law. Thus, plan documents will need to be amended, and we believe that the IRS, this time, will require a new submission for a new favorable opinion letter rather than using a model amendment.

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