THE Pension Digest

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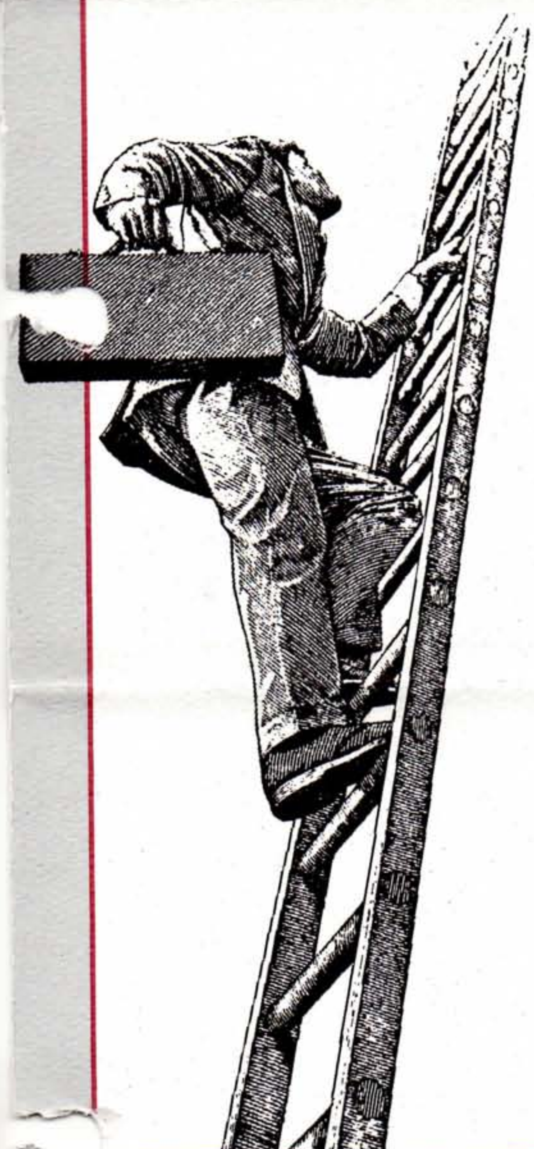
Bush, Congress' IRA Compromise May be Long, Hard Climb



After all the dust raised by President Bush's state-of-the-union message has settled, Americans have returned to the realization that budget proposals are more a Presidential "wish list" than a guarantee of new national policy.

As much-awaited as this event is each year, it is really only the stating of the President's agenda. And, remembering that the road from the White House to Capitol Hill is a two-way street whenever a Congressional majority and the President are of opposite political parties, the experts expect compromise on IRA and pension issues, just like most others.

President Bush Wants . . .

Many believe that if the President were to have his way, he would favor eventual elimination of the traditional IRA, which now gives participants a current tax deduction, a tax deferral on accumulated interest earned, with no taxes paid on either until (for most individuals) retirement time. But few believe that this is a realistic possibility at present.

Bush favors what he calls the Flexible IRA, or FIRA, which generates more immediate tax revenue by not allowing a current tax deduction, but sacrifices future tax revenue by making earnings from the IRA contributions totally tax-free after a period of seven years.

The Bush Administration's proposal is embodied in legislation (H.R. 4051) just introduced by House Minority Leader Bob Michel (R-Illinois), called the Economic Growth Bill of 1992, legislation that includes other topics besides IRAs and pension security issues.

The bill includes a proposal for limited penalty-free access to IRA funds for a first-time home purchase, and for payment of certain medical and educational expenses, without the normal 10% penalty for early withdrawal. This would apply to traditional IRAs, but not to the FIRA.

Although it does not appear to be part of H.R. 4051 introduced by Bob Michel, President Bush was said to initially favor requiring current IRA holders to "liquidate" their conventional IRAs by transferring their account balances to FIRA accounts within a maximum period of four years.

The portions of these account balances that were initially deductible, would have then been immediately taxable upon transfer out of existing accounts. Thus, tax dollars would have been generated immediately.

This more radical approach is seen as quite contrary to what most congressional Democrats would favor, and may not even be broached.

Democratic Preferences . . .

With Democrats very much inclined to give the middle class a tax break, it's likely they would favor an either/both IRA option, allowing accountholders to fund a traditional IRA, a FIRA, or both. If accountholders needed the current tax deduction, they could defer taxation on their deposit and its earnings through a traditional IRA. But if they did not want the deduction now, they could make a taxable (non-deductible) contribution to the FIRA, knowing that the earnings would never be taxed if held for the seven-year period.

Some in the financial industry, however, believe that without the incentive of an immediate tax deduction, many Americans will be disinclined to save through an alternative IRA instrument, such as FIRA.

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Compromise—*Continued from page 1*

Other Provisions Sure to be Debated—Bentsen-Roth, Pickle-Thomas Proposals

Although the Bush administration can almost be counted on to oppose it, the Super IRA bills sponsored by Senators Bentsen (D-Texas) and Roth (R-Delaware), and Representatives Pickle (D-Texas) and Thomas (R-California) offer greater immediate tax incentives for saving through IRAs.

They include

- restoration of full or greater deductibility for more accountholders currently covered by another retirement plan

- indexing of maximum deductible contribution amounts to compensate for inflation

- allowing tax-free earnings after five years, rather than seven as the administration has proposed

- penalty-free use (no 10% tax on early withdrawal) of funds for first-home, medical and educational expenses. This is similar to the Michel bill.

Most in the financial industry favor the Super IRA approach as an incentive for saving, citing the immediate gratification of a tax deduction as the main differentiating point.

Complicated Recordkeeping, Reporting for Banks?

Under current IRA rules, a custodial institution does not need to know if an IRA contribution is tax deductible or not. But if a FIRA option is added, there will be two new needs:

1. a mechanism for transferring non-deductible contributions from current IRAs to the new FIRA account, if the accountholder so desires, and . . .

2. a system for tracking and "timing" the non-deductible contributions made to the FIRA. Why? Because if the accountholder wants to withdraw this account's earnings tax-and-penalty-free, someone will have to determine just when these funds have spent the required amount of time on-deposit, to have earned this tax-free distribution status.

The concept of "first-in first–out" would probably apply, with the earliest contributions-plus-earnings becoming first eligible for tax-free distributions, and so forth. This tracking will be complicated, and the responsibility will probably fall to the custodian.

Dual Data Processing Needed?

Unless the traditional IRA is eliminated and the FIRA is "the only game in town," there will have to be a method to differentiate and report transactions, balances, earnings, etc., on both currently deductible (future-taxable) and non-deductible-plus-earnings bases.

This suggests that two data processing systems will be needed, one for each type of IRA account. Because of the volume of IRA account tracking and reporting done by data processing vendors or "service bureaus," they will quite likely be up-and-running with the proper software to handle these accounts before most individual banks are.

This may mean an initial surge in data processing demand, which hopefully will not have a negative impact on IRA administration deadline and time requirements, and the institutions that must meet them.

Whatever the eventual outcome the upcoming budget sessions should make exciting spectator sport. PD

SEP/Keogh vs. IRA Contribution Choices Not Always Clear

In pension plans, like so many other technical subjects, simple answers aren't always the right answers. Generalities may be "generally" true, but if you're the exception, you might pay a high price to prove the rule.

It's a common generality that if you qualify for a SEP or Keogh plan, you can reap tax deferral benefits much greater than an IRA contribution. For the average worker whose employer has such a plan in force, this is most often the case.

But here's a not-too-uncommon example to the contrary, that should serve as a warning to accountants or financial institution staff who are tempted to give easy, general answers.

Example:

Ralph and Sandy are both employed, and jointly receive $55,000 in compensation annually. Neither has a retirement plan where they work. How much can they take as an IRA tax deduction? A full $2,000 each, for a total of $4,000.

Ralph now begins a part-time mail-order business, in addition to his regular job. In this particular year it earns him $20,000, which boosts their total income to $75,000. Ralph hears from a friend that a SEP plan allows a greater tax deduction than IRAs.

So he opens and contributes to his own SEP plan. Note that he cannot contribute the full 15% that would be possible if he were an employee. As a self-employed individual, he must use an adjusted, reduced percentage formula, or roughly 13.04% (for the sake of simplicity, the adjustment for the self-employment tax has not been factored in).

Ralph can make a $2,608 tax deductible contribution to his SEP plan.

Sound good? It did to Ralph and his wife. But at tax time, when his accountant asked about "other income" and Ralph proudly told him about his mail-order business and his new SEP plan, the accountant cringed.

Why? His SEP contribution made him an "active participant" for IRA purposes. He now had another retirement plan other than his and his wife's IRAs. As an active participant, the deductibility of his IRA contributions was subject to the phase-out formula. With he and his wife's combined incomes greater than $50,000, their IRA contributions became totally nondeductible.

Ralph and Sandy just traded away $1,392 in tax deductibility.

This is why it pays to do all the homework to get a full picture of your customer's retirement plan participation, whether employer or self-funded.

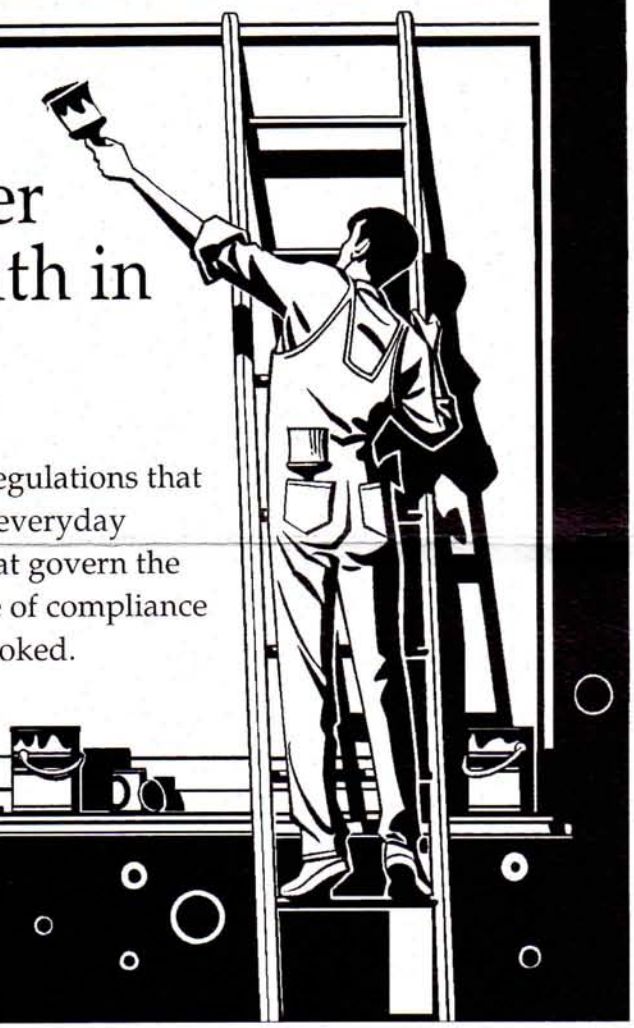
Contribution Calculation for Self-Employed — Keoghs and SEPs

Whether a self-employed customer is considering a SEP or Keogh contribution in addition to, or instead of, an IRA, it's important to properly calculate the maximum allowable contribution.

It used to be a simple matter of adjusting the 15% employee maximum (or $30,000 whichever is less), and taking 13.04% of self-employed income for the maximum contribution. It's no longer that simple. Now the self-employed income level must be first adjusted downward, by an amount equal to one-half the self-employment tax paid for old age, survivors and disability (Social Security) insurance.

For a step-by-step explanation of this formula and how to calculate the maximum Keogh or SEP contribution for a self-employed person, please refer to the 1991 January and February issues of The Pension Digest. PD

More Rules for IRA Advertising . . . under provisions of the Truth in Savings Act



In addition to the technical, pension-specific regulations that IRA custodian institutions must meet in their everyday account administration, there are also rules that govern the way these accounts are promoted. In the maze of compliance issues, these regulations are sometimes overlooked.

The Basic Non-Discrimination Rule

Many are familiar with the rule that incentives to open or make contributions to an IRA account may not include incentives that are not offered to other accounts of a similar nature. If John Doe and Jane Smith each deposits $2,000 in a one-year CD (certificate of deposit), John shouldn't receive 5% interest because his deposit is in an IRA, while Jane receives 3-1/2% interest because hers is in a regular savings account. This is basic.

Requirements of the "Truth in Savings Act"

But less understood is the fact that under the Truth in Savings Act, advertising for IRAs must contain very specific items of information, if the contribution is deposited into an interest-bearing or demand account. Most regular IRA contributions are. This requirement is the same for ANY such account, whether part of an IRA, or simply an interest-bearing savings account.

The Act requires that such ads contain:

• information on the annual percentage yield, and the period during which such annual percentage is in effect

• The minimum account balance and time requirements that must be met in order to earn an advertised yield

• any minimum amount required to open the account at the advertised yield

• notification if the application of any fees or other conditions could reduce the yield

• a statement that an interest penalty will be charged for early withdrawal

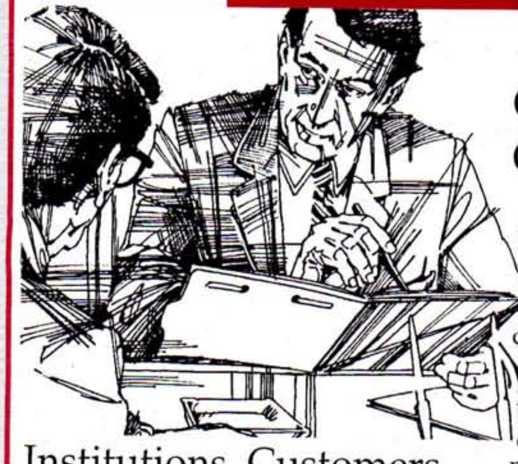
• misleading or inaccurate claims are specifically prohibited

The rationale for these disclosures is to allow customers to make meaningful comparisons between the offerings of competing financial institutions.

Rules Apply to Print, But Not Necessarily to Other Media

Though it seems quite discriminatory, this requirement applies to all print media advertising, such as newspapers or magazines. But it may exempt billboard, radio or TV ". . . if the (Federal Reserve) Board determines that such disclosure would be overly burdensome."

It's easy to see how meeting all these requirements could make billboards unreadable, and radio spots a jumble of regulatory jargon that would obscure any promotional message. Nonetheless, this is a distinct advantage for these media over print ads. Time will tell whether financial institutions will begin to gravitate to these media, in part for their possible freedom from these requirements of the Act. PD



Institutions, Customers Advised on Possible QP Changes

. . . 5/10 Year Averaging, Death Benefit Exclusion May Be Lost

This is a very uncertain time for businesses and individuals because of the potential impacts of tax law changes that will be considered by Congress in the weeks ahead. This session, as in many previous, pension plans will be an area where there will be considerable debate.

Although it is still uncertain, there is speculation that several valued qualified plan provisions may be targeted for elimination. These include:

- 5/10-year averaging — This allows lump sum distributions to be taken from qualified plans (after age 59-1/2), but with their impact on income — and therefore taxation — spread or averaged over a longer period of time. (Ten year averaging is only available to those who reached age 50 by 1/1/86.)

- the Death Benefit Exclusion — This allows up to $5,000 from a lump sum distribution paid to beneficiaries of a qualified plan participant to be sheltered from income taxes.

- capital gain treatment — Up until now, any individual who had attained 50 years of age by 1/1/86 could elect to use capital gain treatment on any qualifying lump sum distribution. Under such circumstances, the capital gain portion of their lump sum distribution is taxed at 20%.

Communicate With Your Customers, and Your Representatives

Please keep these possibilities in mind when advising customers of plan options over the coming months. On a more activist level, financial institutions should consider contacting their congressmen and senators, and questioning the wisdom and fairness of stripping many small or one-person qualified plan participants of these important benefits on which they have relied for a long period of time. PD

Custodians Cautioned on "Coaching" Customers to Waive IRA Withholding

Withholding from IRA distributions for federal income tax is not an option to IRA custodian financial institutions. It IS a customer/accountholder option, but some institutions apparently do not understand the difference.

Without question, it's complicated for a custodian to take 10% from each IRA distribution and handle it as withholding for federal income tax purposes. Whenever an institution sends or hands out to accountholders the required notification that they (most, anyway) can elect-out of income tax withholding, banks hope the customer will do just that. It's so much simpler. Then, only the customer is liable for his or her year-end tax obligation — if any — with no paperwork required of the bank other than filing the customer election as proof.

But recently some evidence of custodian "coaching" has come to light, of banks suggesting that a customer elect-out of federal withholding, or actually telling them "Sorry, our system doesn't allow us to withhold from IRA distributions."

No matter how an institution's data processing or record-keeping systems are set up, handling withholding IS NO OPTION. It's a legal requirement except when waived by the customer. It must be done in all other circumstances.

A Scenario for Liability

Envision a situation in which an IRA accountholder in distribution was persuaded not to have withholding. At year's end, his accountant determines that not only are taxes owed, but a penalty for under-withholding as well.

Does the customer cheerfully accept this turn of events? Or does he litigate against the bank, at the very least to the extent of his penalty?

And, does the IRS turn the other way and condone the bank's actions? Probably not. The custodian institution could very well end up paying an IRS fine, and the accountholder's income tax underpayment penalty.

An unlikely scenario? Uncommon perhaps, but not so unlikely. A neutral position on withholding is the safest stance. PD

"New, Improved" Form for Early Distributions

An IRA accountholder's decision to begin taking account distributions before age 59-1/2 is a critical one. Under only a narrow range of circumstances will they escape the standard 10% penalty tax for early distributions.

Death or disability are the most common reasons this early distribution privilege is exercised. However, some accountholders use the "substantially equal periodic payments" option to take distribution spread over their lifetime. If all requirements of IRS Notice 89-25 are met, no penalty for early withdrawal is assessed.

Financial institutions setting up such periodic payment schedules with accountholders must use a specialized form to obtain several customer elections. For the institution's protection, these forms should contain specific wording that places proper responsibility upon the accountholder for the decisions they make.

The new IRA #55 form, revised 2/92, strengthens the institution's position by requiring the accountholder to acknowledge that he or she has consulted with their tax advisor, takes full responsibility for the tax consequences of the distribution, and has not relied on the institution for any advice concerning such tax consequences.

The new IRA #55 form is now available at current catalog prices.

For further information, or to place an order, contact the customer service department at Collin W. Fritz and Associates, at 1-800-346-3961. PD