The Pension Digest

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What Tax/Pension Provisions May Lie in Store in Clinton Presidency?

While most do not expect the transition from a Bush presidency to a Clinton presidency to usher in an era of New Deal spending and radical economic policy, many revenue experts believe that there will be significant changes, and "business as usual" for taxpayers will be a thing of the past.

Here are some of the rumored and/or possible effects of Clinton economic policy on several important areas of the U.S. tax/revenue environment.

Impact on Retirement Plans

Two words serve to introduce this subcategory: Lloyd Bentsen. Bentsen has just recently been appointed Secretary of the Treasury by President-elect Clinton. Bentsen has been a strong advocate of liberalizing IRA provisions. With a supportive Democratically-controlled Congress, look for any or all of the following:

* penalty-free IRA withdrawals for new home purchase, higher education costs, or major medical expenditures for those who are unemployed.

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IRA Custodians Reminded on Withholding Notice, Election Rules

Year's end is a time of heightened activity for financial institution IRA departments, in part because of the urgency for many IRA accountholders to make elections, and to take required distributions to meet their RMD requirements, avoiding the consequence of an excess accumulation penalty for having an under-distributed IRA. In the past, there was also the potential for having one's entire IRA account distributed to them, if the proper election was not made in a timely fashion.

Among those IRA items of importance for custodians to consider is the compliance requirement to give proper notice to customers of their options with respect to federal income tax withholding from their IRA distributions. This requirement was covered in great detail in the December 1991 issue of *The Pension Digest*, which you may wish to refer to. An abbreviated summary of these requirements is provided here, because of the timeliness of this topic.

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* indexing of IRA deductibility: allowing full IRA deductions for couples making roughly $100,000 or less, individuals roughly $75,000 or less. (This may not take effect for two to three years, because its immediate effect is to reduce taxes and raise the deficit, something the administration may be reluctant to do.)

* a back-ended IRA, allowing nondeductible contributions with *tax-free* earnings after a fixed period, five years if past proposals are any indication.

Impact on Retirees/Social Security Recipients

* taxation of a higher percentage of Social Security benefits, depending on income. Currently, 50% of SS benefits are taxable for couples earning more than $32,000, or individuals earning more than $25,000.

* higher rate of Medicare payment cost-sharing for retirees with higher incomes. One income figure mentioned is $125,000 or more.

Impact on Tax-Advantaged Investing

* possible modification of tax-free status of municipal bond investments

* the tax credit for investment in low-income housing is expected to be extended for another year, with no promises thereafter.

* possible taxation of a portion of health benefits provided by employers to employees.

* reduction or elimination of the income cap on wages subject to Medicare taxation. The cap is now $130,200, the tax rate 1.45%.

* possible reduction of maximum value of a tax-free estate that may be left to heirs. Currently this maximum is $600,000.

* possible requirement that capital gains taxes apply to assets owned at the time of death.

Impact on Small Business

* tax deduction for health insurance premiums.

* an investment tax credit on such purchases as vehicles and business equipment.

Impact on Taxpayers in General

* loss or lowering of income phase-out levels for some common itemized tax deductions, for those considered to be "high income". Currently, phaseout level for such things as personal and dependent deductions begins at $105,250 for single filers, $157,900 if married.

* increase in the maximum tax rate for those with incomes over $200,000 ($150,000 if single). Figures sometimes quoted include an increase from 31% to 36%.

* tax surcharge on those with $1 million incomes, of as much as 10%.

Other possibilities include:

* lower the cap on deductible home equity loan debt, currently $100,000.

* eliminate deduction of interest on second homes.

* reduce the cap on deductible mortgages for first homes, currently set at $1,000,000.

* a broad "consumption" tax, which could shift some of the burden for revenue raising away from income taxes.

All eyes will be on Washington, the Clinton administration and Congress in the months to come, to see which if any of these or similar proposals find their way to the signing desk of the President. PD

New Codes Added for 1099-R Reporting

The new rules mandating withholding on distributions from qualified plans and tax sheltered annuities (called for in the Unemployment Compensation Amendment of 1992) are effective as of January 1, 1993. They not only prescribe withholding of 20% from distributions taken by QP and TSA participants, but have resulted in code changes for 1993 reporting on the 1099-R distribution form.

New for 1993 are codes "G" and "H".

Distribution Code G — Distribution code G identifies a direct rollover from a QP or TSA to an IRA account. Although the transaction is not new, the term "direct rollover" is a new development with this piece of legislation. It is the direct transfer of funds from the QP plan to the accountholder's IRA at a bank, S & L, trust company, credit union or other entity empowered to act as IRA custodian. By the terms of this direct rollover, the funds — administratively and technically not a distribution — are never made payable to the accountholder, though he or she may receive and relay a check that is made out to the (new) custodian.

Distribution Code H — This code is used for the direct rollover of funds from one QP or TSA to another QP or TSA. Similar to above, this transaction is a direct transfer of funds without actual distribution, but in this case plan-to-plan rather than plan-to-custodian/trustee.

Boxes 12, 15 Added As Well

Box 12 is now used to report that part of a distribution that is subject to an applicable state tax.

Box 13 is the old Box 12 (local income tax withheld)

Box 14 is the old Box 13 (name of locality)

Box 15 is used to report that part of a distribution subject to local taxation. PD

Don't Forget January Reporting of IRA Fair Market Value

Although we have covered the subject in great detail in the past, we'd like to remind Pension Digest subscribers of the importance of properly-prepared and timely reports to customers of the year-end fair market value (FMV) of their IRAs, better known as the "customer statement". The deadline for this reporting is January 31, 1993 for the 1992 FMV.

We would like to refer you back to the November 1991 issue of *The Pension Digest* for a complete discussion of all aspects of this reporting task, as well as other reporting requirements including 5498, 1099-R and 8606 (copies are available by sending $2.00 plus a stamped, self-addressed envelope to *The Pension Digest*, P.O. Box 426, Brainerd, MN 56401). Covered in that issue are such things as:

* who is entitled to receive a customer statement

* notes on deceased accountholders

* identifying an inherited IRA account for customer statement reporting

* customer statements and the 5498 exception

* incorporating special required information on customer statements

* penalties for late filing, or for failure to file

* rules on enclosures with customer statements

If you have any questions on customer statements, and are a CWF consulting customer, we will be glad to speak directly with you on issues relating to this reporting. If not, this is one more reason to consider beginning a consulting relationship with CWF, to help you keep your IRA plans in full compliance. Call 1-800-346-3961. PD

20% Withholding Rule Under Attack

pponent Seeks Repeal

One of 1992's blockbuster taxation rule changes — the Unemployment Compensation Amendment (UCA 92) mandate for 20% withholding on distributions from QP plans and annuities — is being given serious attention by one legislator for a possible repeal effort. However, there are few indications as yet that there will be broad-based Congressional support for such an initiative. The new rules take effect 1/1/93, requiring all distributions otherwise qualified for rollover to have 20% withheld, unless the distribution is transferred directly into another retirement plan, including an IRA.

Proponents have praised the law as a means to reduce lost tax revenues and induce employees not to unwisely dissipate their retirement funds, and in fact there have been some collection problems in the past. But, some critics have characterized the plan as a political sleight-of-hand whose only real benefit will be to move 1994 tax collections into the 1993 fiscal year. Official government estimates (according to a report in *Money Magazine*) place anticipated tax revenues generated as a result of the new rule at $2 billion in 1993, and roughly $1 million in 1994. Critics, ch as Ernst & Young's Director of Tax actices David Berenson, point to this as a actor that will contribute to a fiscal year 1994 deficit.

Critics further contend that the primary reason for Congressional acceptance of this provision of UCA 92 was the need for a tax source for the extended unemployment compensation benefits of the bill, in order to assure a presidential signature rather than a veto.

Will Some Terminate Plans Rather Than Administer 20% Withholding?

Others report "word on the street" that some firms, especially those with modest administrative resources to begin with, will simply terminate their pension plans rather than be placed in a position of not only having to execute UCA provisions, but potentially taking on the risk of fiduciary liability, should they inadvertently mishandle transactions to an employee's tax disadvantage.

U.S. Representative Jan Meyers, (R-Kansas) is actively seeking repeal of the 20% withholding rule. Approximately 50 of the 535 members of Congress are reported to have pledged co-sponsorship support.

In addition to the possibility of other gnificant pension plan revisions under a ew administration, this issue will be one of those most worthy of watching in the coming year. PD

New FDIC Insurance Limits Will Affect Retirement Plan Deposits

...reduced insurance limits effective 12/93

New limits on FDIC liability for certain retirement plan deposits are set to take effect December 19, 1993, according to the terms of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA 1991). Certain other provisions of the Act, applying to general FDIC issues, are already in effect.

Plans whose FDIC protection will be reduced under the new rules include IRAs, and any Section 3(34) ERISA plan or 401(d) plan whose participants may direct their own plan investments. This will be discussed in greater detail shortly.

A Little Perspective...

While most general savings accounts have maximum FDIC insurance protection of $100,000 per accountholder, certain retirement plans have been an exception. Not only has their maximum coverage been treated as being *in addition to* general savings account insurance coverage, but — under rules in effect since the merging of FDIC and FSLIC functions — *each separate plan type (IRA, Keogh, etc.)* given coverage has had its own $100,000 limit. This translates into significantly greater potential loss exposure for FDIC.

Separate Retirement Plan Insurance Limit Treatment Will End

This approach of separately insuring IRAs, Keoghs, etc., each plan type to the $100,000 maximum, has now been reversed in favor of the original FDIC approach, which is the aggregating of retirement plan amounts to arrive at a single $100,000 maximum of liability, with one exception.

Separate Provision Gives Retirement Plans Added Year Before Aggregation Requirement

The following language from FDICIA 1991 applies until December 19, 1993, and is excerpted from Section 11(a)(3) of the Act:

"Notwithstanding any limitation in this chapter or in any other provision of law relating to the amount of deposit insurance available for the account of any one depositor, time and savings deposits in an insured depository institution made pursuant to a pension or profit-sharing plan described in section 401(d) of title 26, or made in the form of individual retirement accounts...as described in section 408(a) of title 26, shall be insured in the amount of $100,000 per account."

New Language Effective December 1993

In general, for any IRA, deferred compensation plan, and any Section 3(34) ERISA plan or 401 (d)* plan whose participants or beneficiaries may direct investment of plan assets, deposits will be aggregated and limited to $100,000, per participant per insured depository institution.

*...An Important Exception

The above reference to a "Section 3(34) ERISA plan or 401(d) plan whose participants may self-direct investment of plan assets..." defines the exception to this new aggregation rule.

If such a plan is held by an employer "for the benefit of" its employees, but does not afford them the right to self-direct investments, then any amounts held for their benefit will not be aggregated with retirement plan deposits they hold as individuals, in calculating the $100,000 aggregate limit for insurance coverage.

(Further exception: This does not apply to any deposit made before December 19, 1991, and maturing after December 19, 1993, except for rollovers or renewal of time deposits, which will be treated as new accounts.)

In Summary...

As stated previously, this aggregate limit of $100,000 insurance coverage applies specifically to these described retirement plans, and is *in addition to* other general savings accounts on deposit in any one institution. But it does in effect reduce the FDIC's liability significantly.

Institutions May Wish to Advise Customers on Diverting Deposits

For institutions that are a part of a related banking or financial group, such as a holding company, or "family" of institutions, it may be advisable to take a proactive stance and recommend that customers move funds when maximum aggregate limits are approached. This affords the opportunity to influence the customer to keep his or her funds within your financial group, rather than having them take the initiative to remove funds, and possibly place them with a competitor. PD

IRA Custodians—*Continued from page 1*

70 1/2 Elections vs. Distribution Schedule

When a customer turns 70 1/2 and must begin taking required minimum distributions, (RMDs), he or she makes an election that will govern the future calculation of their RMDs, based on such things as their age, beneficiary(ies) if applicable, and their choice of the recalculation or non-recalculation method (reduction-by-one) for RMD calculation.

But this is something quite different from their distribution schedule, which may be set up as single or multiple distributions per year, scheduled or irregular, to simply equal the RMD, or perhaps to exceed it. The two are related, but should not be confused with one another.

What is IRA Withholding, and the IRA "Withholding Notice"?

Because all IRA assets are generally taxable upon distribution (with the exception of the customer's basis in nondeductible IRA contributions), the U.S. government is concerned with receiving its fair share in taxes. For this reason it has imposed a withholding mechanism for IRA distributions.

Amount That Must Be Withheld

For IRA accounts payable upon demand - the majority of IRAs - there is an automatic withholding of 10%, unless the customer chooses to waive this withholding, or to increase it by a dollar amount above 10%.

Accountholders also have the right to change their withholding election at any point in the future if they so choose. Estimated tax rules may apply however, so accountholders should be cautious not to find themselves owing excessive amounts at year's end.

For accounts not payable upon demand, withholding is calculated from the wage tables, much like employee earnings would be.

On What Form is the Withholding Notice Given?

The IRS form W-4P or a private vendor derivative can be used to handle the notice and customer election requirement. Collin W. Fritz and Associates' #59-series forms offer custodians several options for obtaining the needed election and fulfilling the notice requirement (call 1-800-346-3961 for more information on these forms.)

Periodic vs. Non-periodic Distributions: Frequency & Timing of Withholding Notice

In the eyes of the regulatory powers, it is the custodian/trustee's responsibility to make IRA customers aware of their withholding options. This is done by providing them with a "withholding notice." Just how often depends on the distribution schedule set up by the customer.

If the distributions are taken on a regularly scheduled basis, and at least as often as quarterly, then a notice is to be given with the first distribution (15 days before or after is allowed, but before or concurrent are preferred by the IRS), and thereafter only one annual notice is required, to be given within a reasonable time *before* the first distribution for each succeeding calendar year.

Many financial institutions choose to mail this notice with the IRA Customer Statements mailed to each accountholder by January 31 of each year, showing the IRA balance as of the previous December 31.

If distributions are not regularly scheduled, or are not taken as often as quarterly, then they are considered to be non-periodic distributions, and a withholding notice is to be given for each distribution. Technically, this notice can be sent as early as six months before the distribution, and no later than would allow the accountholder time to make an election to have no withholding apply. However, the prudent and sensible approach is to provide the withholding election notice within a reasonable time beforehand, rather than at the time of distribution.

Although the above rules may at times seem complicated and burdensome for IRA custodians/ trustees, they are a further example of the IRA regulations erring on the side o keeping an IRA accountholder informed, with the responsibility for that function falling to the financial institution.

"Timing is Everything," in IRA Election Process Too

Intentions that are not exercised in life cannot be exercised by proxy after death, no matter how much evidence exists to verify intent. This was the opinion expressed in IRS Letter Ruling 9237038, issued July, 1992.

The executor of the estate of a former "surviving spouse" of an IRA accountholder was not able to make a valid election in accordance with that (later deceased) spouse's wishes, this letter ruled.

This spouse was the designated beneficiary of her husband's IRA. Her estate was the contingent beneficiary, both so named by the husband/ accountholder. Following his death, she indicated that she intended to elect to treat his IRA as her own, and to designate her son as beneficiary. This would lengthen the period of distribution. An appointment had been made with the institution, acting as custodian for her inherited IRA, to complete the paper work necessary to make this change.

But before this appointment could be kept, the surviving spouse also died. Could her estate's executor carry out her wishes, which were so clearly expressed? "No," said the IRS. Only she, as a surviving spouse, could make such an election. The account must therefore become part of her estate, to be distributed in accordance with her will, if any, or the laws of probate in her state of residence.

Plan Exists for the Benefit of the Retiree

This is one more example of the IRS philosophy that such plans as IRAs exist for the sake of the accountholder, and specifically to fund their retirement, rather than existing for the purpose of estate building for those who might inherit. Absent her executing the election herself, her estate inherits the IRA.

Question: Though there has been a lot of publicity on it, I'm still somewhat confused about the new requirement to withhold 20% from pension distributions, if they are not transferred or directly rolled-over to another retirement plan. Does this apply to IRA distributions?

✓ Answer: This is a question we are hearing very frequently. The answer is "no." The statute is very clear. The 20% withholding applies to qualified retirement plans and tax sheltered annuities, not IRAs.

IRA withholding rules have not changed.

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.