THE Pension Digest

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IRA Holders May Be Affected By Social Security Law Change

Due to provisions of the Omnibus Budget Reconciliation Act of 1993 (1993 tax bill, effective Jan. 1, 1994, and thereafter), there are two significant impacts that may be felt by IRA accountholders who receive Social Security benefits.

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First, there have been changes in the formula and thresholds for Social Security (SS) benefit taxation. Some accountholders will have more of their SS benefits included in their adjusted gross income (AGI) and taxed. Those who are employer retirement plan "active participants" may see a drop in their IRA contribution deductibility. Second, distributions from IRAs may raise income and result in increased taxes on Social Security benefits.

I. Effect of Higher SS Benefit Taxation on IRA Deductibility

For many workers, their adjusted gross income – or AGI – directly affects the deductibility of their IRA contribution. These are workers who themselves (or their spouse) are "active participants" in an employer-sponsored retirement plan. These active participants may deduct their IRA contribution, but only within certain AGI limits.

(A two-income couple, for example, may deduct $4,000 in IRA contributions – $2,000 each – if their joint AGI is less than $40,000 per year. But they receive no deduction if their AGI is $50,000 or more. If their AGI is between $40,000 and $50,000, their deduction will be an intermediate amount. Comparable amounts for an individual are $25,000 and $35,000.)

How Higher SS Taxation May Boost AGI, Reduce Deductibility

The taxable portion of Social Security benefits is included in one's AGI. One segment of those receiving SS benefits – the highest income bracket – will now be taxed at a higher rate, and thus will have a higher AGI under the new law.

Some estimate that about 13% of senior citizens will be affected by the higher taxation rate.

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What Are Typical Social Security Benefits?

To give some additional perspective, here are some typical benefit amounts for an individual or couple receiving a Social Security benefit:

1. Single Retiree Age 65 or Older: $674/month = $8,088/year
2. Single Retiree Age 62 to 65: $539/month = $6,470/year
3. Retired Couple Age 65 or Older: $1,140/month = $13,680/year
4. Retired Couple Age 62 to 65: $912/month = $10,944/year
5. Aged Widow or Widower ("non-working," drawing on benefit of deceased spouse): $631/month = $7,572/year

The Social Security Benefit "Hold-Back"

For SS benefit recipients under age 65, one-half of each benefit dollar is "held back" for each dollar of W-2 and self-employment income that exceeds $8,040 (up to the benefit maximum). For SS recipients age 65-70, one-third of each benefit dollar is "held back" for each dollar of W-2 and self-employment income that exceeds $11,160 (up to the benefit maximum). There is no hold-back of SS benefits for recipients age 70 or older. PD

Senate Begins Work on Tax Simplification

In the November 1993 Pension Digest, we reported on HR 3419, the House of Representatives' Tax Simplification and Technical Corrections Bill. This bill contained numerous pension provisions. Now, preliminary work by the Senate Finance Committee tax staff has begun on a Senate version of a similar tax simplification bill.

As of this writing, pension provisions to be included in the Senate bill are still being discussed at the staff level. But it is likely that some will resemble or mirror those of the House bill. The Senate hopes to move briskly to have their own version ready in the event that H.R. 3419 reaches the full House and is passed.

Given the likelihood of action on both House and Senate bills, here is a brief recap of some of the more important pension provisions of the House bill, as reported by Chairman Dan Rostenkowski's (D-IL) Ways and Means Committee:

1. Eliminate five-year-averaging of lump-sum plan distributions.

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Also in this issue

Illustrating the Effects of the Law Changes on Social Security Benefit Taxation

The Omnibus Budget Reconciliation Act of 1993 changed the rules governing taxation of Social Security benefits. Shown below is a summary of these new rules, taken from an amendment based on IRS regulations. Shown below is a non-technical summary and illustrations of the practical consequences of these new rules.

*"**Effect on Taxation of Social Security and Railroad Retirement Benefits.** Commencing with the 1994 tax year (i.e. January 1, 1994), new rules govern when Social Security benefits and tier 1 Railroad Retirement benefits must be included in a taxpayer's gross income. If you receive such benefits, then you must include a portion of these benefits in your gross income. If you receive such benefits, then you must include a portion of these benefits in your gross income if your provisional income exceeds either of two threshold amounts. Your provisional income includes modified adjusted gross income (adjusted gross income plus tax-exempt interest plus certain foreign source income) plus 50% of your Social Security or Railroad Retirement benefit.*

"If your provisional income exceeds the following applicable threshold amount – $32,000 for married taxpayers filing joint returns, $25,000 for unmarried taxpayers and $0 for married taxpayers filing separate returns – then you are required to include in gross income the lesser of (1) 50% of your Social Security or Railroad Retirement benefit or (2) 50% of the excess of your provisional income over the applicable threshold level.

"If your provisional income exceeds the following applicable threshold amount – $44,000 for married taxpayers filing joint returns, $34,000 for unmarried taxpayers and $0 for married taxpayers filing separate returns, then you are required to include in gross income the lesser of (1) 85% of your Social Security or Railroad Retirement benefit or (2) the sum of 85% of the excess of your provisional income over the applicable threshold level plus the lesser of (a) the amount determined using the applicable threshold described in the immediately preceding paragraph or (b) $4,500 if you are unmarried, $6,000 if you are married and filing jointly, and $0 if you are married but are filing a separate return.

"The consequence of this rule may be: (1) if you are an active participant, any taxable Social Security amounts will increase your AGI for purposes of the deductible/nondeductible calculation and (2) a distribution from your IRA could result in some of your Social Security benefits being taxable."

The concept of the law change for single individuals is as follows:

1. Those people with provisional incomes (other income plus one-half SS benefit) $25,000 or less will have none of their Social Security benefits included in income for income tax purposes;

2. Those people with provisional incomes in excess of $25,000 up to $34,000 will include in their income for income tax purposes the lesser or:

a. 50% of their Social Security benefit; or

b. 50% of his or her provisional income which exceeds $25,000.

3. Those people with provisional income in excess of $34,000 up to $36,794* will include in their income an increasing percentage ranging from 51% to 85%.

4. Those people with provisional income in excess of $36,794 will include in their income 85% of their Social Security benefits.

* This "cutoff" amount can vary and is dependent upon which variable from the new formula is used: the lesser of $4,500 (b) or the amount includible in 1993 (a).

The concept of the law change for married people filing jointly is as follows:

1. Those couples with provisional incomes of $32,000 or less will have none of their Social Security benefits included in income for income tax purposes;

2. Those couples with provisional incomes in excess of $32,000 up to $44,000 will include in their income for income tax purposes the lesser of:

a. 50% of their Social Security benefit; or

b. 50% of his or her provisional income which exceeds $32,000.

3. Those couples with provisional income in excess of $44,000 up to $50,617* will include in their income an increasing percentage ranging from 51% to 85%.

4. Those couples with provisional income in excess of $50,617* will include in their income 85% of their Social Security benefits.

*This "cutoff" amount can vary and is dependent upon which variable from the new formula is used: the lesser of $6,000 (b) or the amount includible in 1993 (a). PD

Example 1: Joe is single and has income of $40,000 in addition to his Social Security benefit of $8,088. What amount of his $8,088 did he have to include in income for 1993 income tax purposes? What amount of this $8,088 will he have to include in gross income in 1994? His provisional income is $40,000 plus 50% times $8,088 or $44,044.

Calculation for 1993 — He must include the lesser of:

1. 50% times $8,088 = $4,044; or
2. 50% ($44,044 - $25,000) = $9,522.

The lesser amount is $4,044.

Calculation for 1994— He must include the lesser of:

1. 85% times $8,088 = $6,875; or
2. 85% ($44,044 - $34,000) + the lesser of $4,500 or the amount which would have been paid in 1993 ($4,044) = $12,581

$8,537 + $4,044 = $12,581

The lesser amount is $6,875. Thus, Joe must include in income for 1994 purposes $6,875, whereas he only had to include $4,044 in 1993. The amount of tax he would owe for 1994 would depend on his marginal tax rate:

— at 15%: $1,031, which is an increase of $424 over the 1993 amount of $607;

— at 28%: $1,925, which is an increase of $793 over the 1993 amount of $1,132; or

— at 31%: $2,131.

Example 2: Mary and Tom are married and file a joint return. They receive Social Security benefits of $13,680. In addition to their Social Security benefits, they have additional income of $39,000. What amount of this $13,680 did they have to include in income for 1993 income tax purposes? What amount of this $13,680 will they have to include in gross income in 1994? Their provisional income is $39,000 plus 50% times $13,680 or $45,840.

Calculation for 1993 — They must include the lesser of:

1. 50% times $13,680 = $6,840; or
2. 50% ($45,840 - $32,000) = $6,920.

The lesser amount is $6,840.

Calculation for 1994 — They must include the lesser of:

1. 85% times $13,680 = $11,625; or
2. 85% ($45,840 - $44,000) + the lesser of $6,000 or the amount which would have been paid in 1993 ($6,840). = $7,564

$1,564 + $6,000 = $7,564.

The lesser amount is $7,564. Thus, Mary and Tom must include in income for 1994 purposes $7,564, whereas they only had to include $6,840 in 1993. The amount of tax they would owe for 1994 would depend on their marginal tax rate:

— at 15%: $1,135, which is an increase of $109 over the 1993 amount of $1,026;

— at 28%: $2,118, which is an increase of $203 over the 1993 amount of $1,915; or

— at 31%: $2,345.

Example 3: Elle and Ricardo are married and file a joint return. They receive Social Security benefits of $13,680. In addition to their Social Security benefits, they have additional income of $80,000. What amount of this $13,680 did they have to include in income for 1993 income tax purposes? What amount of this $13,680 will they have to include in gross income in 1994? Their provisional income is $80,000 plus 50% times $13,680 or $86,840.

Calculation for 1993 — They must include the lesser of:

1. 50% times $13,680 = $6,840; or
2. 50% ($86,480 - $32,000) = $27,420.

The lesser amount is $6,840.

Calculation for 1994 — They must include the lesser of:

1. 85% times $13,680 = $11,625; or
2. 85% ($86,840 - $44,000) + the lesser of $6,000 or the amount which would have been paid in 1993 ($6,840). = $42,414

$36,414 + $6,000 = $42,414

The lesser amount is $11,625. Thus, Elle and Ricardo must include in income for 1994 purposes $11,625, whereas they only had to include $6,840 in 1993. The amount of tax they would owe for 1994 would depend on their marginal tax rate:

— at 15%: $1,744, which is an increase of $718 over the 1993 amount of $1,026;

— at 28%: $3,225, which is an increase of $1,340 over the 1993 amount of $1,915; or

— at 31%: $3,604.

Social Security

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If these individuals and couples are active participants in an employer retirement plan, and still make IRA contributions, their contribution deductibility may be reduced.

Those Not Affected

• Those in the lowest income bracket – individuals having $25,000 or less, or couples $32,000 or less of provisional income (defined as other income plus one-half the SS benefit) – will continue to pay no tax on their Social Security benefits.

• The next tier, those in excess of $25,000 up to $34,000 provisional income as an individual, or in excess of $32,000 up to $44,000 as a couple, will continue with the current formula for Social Security taxation.

Those Affected

• Those SS recipients in excess of $34,000 provisional income individually, or couples with a combined provisional income in excess of $44,000, have a new benefit taxation formula. (See page 2 for examples illustrating the effects of these law changes.)

II. IRA Distributions May Increase Social Security Taxation

Provisions of the new law may also produce higher taxation of SS benefits for some who receive IRA distributions.

Example #1 — Joe Pierce will have 1994 income of $20,000, before considering any money that he may withdraw from this IRA. For 1994 he will receive a SS benefit of $8,088. He wants to know what the tax consequences will be if he elects to withdraw $5,000 from his IRA at the end of 1994.

He knows that he will have to pay income tax on the withdrawal of $5,000. But will this withdrawal cause him to have additional tax liability? The answer is "yes," as you will see in the column at right.

Given the above amounts of income, SS benefit and IRA distribution, Joe's provisional income would be $29,044:

$20,000	income
+ $4,044	(1/2 of $8,088 SS benefit)
+ $5,000	IRA distribution
$29,044	provisional income

This puts him within the $25,000 to $34,000 excess provisional income framework. Therefore 50% of excess provisional income ($29,044 - $25,000) will be taxed, or $2,022 ($4,044 x 50% = $2,022). He will not be taxed on 50% of his SS benefit - $4,044 — because in this calculation you are to choose the LESSER of option (1) 50% of SS benefit, vs. option (2) 50% of excess provisional income.

If Joe is in the 15% tax bracket, his tax liability on this $2,022 excess provisional income amount will be $303.30. Had Joe not had a distribution that pushed his provisional income over the $25,000 threshold, he would not have had to pay the $303 on his excess provisional income. **(Note that this amount is the same as under the old law.** At this income level, the threshold remains unchanged.)

Example #2. If Joe had taken a distribution of $10,000 instead of $5,000, his provisional income would have been $34,404 ($20,000 income + 1/2 his $8,088 SS benefit ($4,044) plus his IRA distribution of $10,000). He would have exceeded the $34,000 excess provisional income threshold. Because of this, 85% of his SS benefit, or 85% of his excess provisional income — whichever is less — would have been taxed, instead of the 50% rate at the lower threshold level, as calculated above.

Don't Always Delay IRA Distributions

It may not always be advantageous to delay distributions as long as possible. If there are years in which other income plus SS benefits find an IRA accountholder below a taxation threshold, it may be wise to take a larger distribution in that year. PD

Tax Simplification

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2. Repeal the Death Benefit Exclusion, which allows the beneficiary of a deceased plan participant to receive $5,000 tax free.

3. Provide a simplified method for taxing annuity payments from a qualified plan, 403(b) tax sheltered annuity or IRA.

4. Include changes in the required minimum distribution rules for 5% and non-5% business owners.

5. Reporting penalty provisions of Internal Revenue Code sections 6721, 6722 and 6724 would be extended to apply to IRAs. IRA custodians would then be liable for incorrectly prepared IRA reporting forms, not just failure to complete these forms.

6. Per-failure and annual maximum penalty payments would be increased for qualified plan administrators who fail to properly provide a 402(f) notice (describing participants' distribution options and withholding requirements).

7. Broaden eligibility of small businesses to use a salary reduction (SAR-SEP) SEP plan, by:

a. increasing from 25 to 100 the maximum number of employees a business may have and still qualify for a SAR-SEP; and

b. repeal the requirement that 50% of eligible employees must participate in order to have a SAR-SEP plan.

8. Allow some tax-exempt organizations to have 401(k) plans.

9. Simplify the definition of "highly compensated employee."

10. Create new safe harbors for 401(k) plans.

11. Create new rules for the treatment of governmental plans under section 415.

Watch *The Pension Digest* for further developments on both House and Senate tax-simplification bills. PD

Social Security Changes Part of Amending Requirement

The information contained in this issue of *The Pension Digest* concerning the changes to Social Security taxation brought about by OBRA '93, is part of the amending requirement for IRA plans.

In past issues of *The Pension Digest*, we have discussed our recommendations for the timing of this amendment. Many institutions amended for these law changes with their January 1994 customer statement mailings. Others are considering the option of mailing at the Form 5498 mailing deadline of May 31st. To those institutions considering delaying their amending beyond that date, on the possibility of additional IRA changes before year's end, we strongly recommend that plans be made and amending take place no later than December 31, 1994. We feel that this is the latest prudent date by which such amending should take place.

Be certain not to forget this responsibility. PD

Proper Approaches to Charging Certain Fees

The number of institutions charging distribution or close-out fees with respect to their IRAs seems to be growing. An administrative question which arises is, "Should we as the IRA custodian allow customers to pay our fees with non-IRA funds?" That is, some would rather pay by check than have the fees deducted from their IRA balances. These customers would like to be able to deduct these fee payments as a miscellaneous deduction on their personal income tax returns.

Under the current state of the law, it is best if your institution adopts the approach of charging this fee against the IRA funds and not allowing your customer to pay these fees with non-IRA funds.

The IRS has addressed in writing only two types of fees: (1) trustee fees and (2) brokerage fees. The IRS has not adopted a written policy on any other types of fees.

With respect to trustee fees, the IRS has ruled that the individual could pay these with non-IRA funds, and that he or she could consider this as an expense deductible under sections 162 or 212 as a miscellaneous deduction.

With respect to brokerage fees, the IRS has ruled that these fees must be paid by the IRA account itself, as these fees are intrinsic to the IRA investments. The IRS stated that if an IRA custodian did allow a person to reimburse the IRA for the brokerage fees, that these payments would constitute contributions which must be reported on the Form 5498 and which would count against the person's $2,000/100%-of-compensation contribution limit. Note the requirement to report such payments as contributions on Form 5498.

Since the IRS has not settled the handling of distribution and close-out fees, the conservative approach is to require that these fees be assessed against the IRA account itself. If you do allow the individual to pay these fees separately, you should report such payments as a regular contribution. PD

Correction

In the February *Pension Digest* article on cost-of-living adjustments for qualified plans and SEPs, we indicated that the SEP and Qualified Plan Maximum Compensation cap for 1993 is $235,940. It is in fact $235,840.

Iowa State Income Tax Withholding on Qualified Plan Distributions

An announcement from the Iowa Department of Revenue has cleared up confusion regarding Iowa state withholding.

For some time the state of Iowa has required that state income taxes be withheld on IRA and qualified plan distributions. With the change in the Federal withholding rules for qualified plans in 1993, a clarification in Iowa state withholding has been needed.

The Department of Revenue announced that a distribution from a qualified plan that is not directly rolled over to an IRA may be subject to Iowa state tax withholding. This means that distributions that are subject to the 20% Federal withholding are also subject to Iowa withholding if they are not directly rolled over. The percentage for the Iowa state withholding is 5%.

Unlike Federal regulations which require Federal withholding on qualified plan distributions that exceed $200 annually, Iowa rules state that if the gross amount of the qualified plan distribution is less than $2,400, state withholding will not be required. This could mean that many qualified plan distributions that are subject to Federal withholding would not require Iowa state withholding.

These rules apply only to qualified plan distributions. The Iowa withholding rules for IRAs remain the same and were discussed in earlier issues of *The Pension Digest*. For more information, contact CWF or the Iowa Department of Revenue. PD

✔✔✔ Check It Out ✔✔✔

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

Question: We have a customer who has a self-directed IRA. He wishes to lend some of his IRA funds to his daughter. Will this be a prohibited transaction?

✔ **Answer:** Yes. Since your customer self-directs his IRA, he is a fiduciary. A PT will occur if he makes a loan to any member of his family. The law defines the family of an individual to be his or her spouse, ancestor, lineal descendant or spouse of a lineal descendant.

Question: Our customers, Tom, age 54, and Janice, age 53, have $8,000 and $33,000, respectively, in their IRAs. Tom is disabled for IRA purposes. If Tom takes distributions from his IRA, will the 10% excise tax apply? If Janice takes distributions from her IRA to assist with Tom's medical bills, will the 10% excise tax apply?

✔ **Answer**. The 10% excise tax will not apply to distributions to Tom since he is disabled. The 10% excise tax will apply to distributions to Janice since she is not disabled. This may seem harsh, but that is the current law.

Question: Our customer used to maintain an annuity with an insurance company. He surrendered the annuity policy on 12-22-93. The insurance company sent a Form 1099-R to him on 1-15-94. Does the fact that he received a Form 1099-R mean he is entitled to roll over these funds?

✔ **Answer**. No. There are IRA annuities, QP annuities and general annuities. General annuities are not eligible to be rolled over into an IRA. A 1099-R form is to be prepared for distributions from general annuities as well as IRAs and QPs, so one cannot conclude that a rollover is permissible just because there is a Form 1099-R.

Question: Our bank does not seem to be consistent in preparing IRS Form 1099-R. What possible liabilities does the bank face?

✔ **Answer**. Current law does not impose any penalties if the Form 1099-R is prepared incorrectly, although Congress is considering such a change. However, if you fail to prepare a Form 1099-R which was required to be prepared, the IRS can impose substantial penalties. The penalty is $25 per day for each form which was required to be but was not prepared, to a maximum of $15,000 per year. Be sure you are preparing the Forms 1099-R that you are required to.

Example: Peter Brown died on 12-10-93 with $15,000 remaining in his IRA. His daughter, Elsa, is paid this entire amount on 12-31-93. The bank, as the IRA custodian, prepares the 1993 Form 1099-R in Peter's name and not Elsa's name.

The bank prepared the form in Peter's name incorrectly. No penalty would apply. The bank failed to prepare the form in Elsa's name. Thus, the $25-per-day penalty will apply until it is prepared. PD