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Another IRA Law Change Proposal

On January 4, 1995, senators Bill Roth (R-Del.) and John Breaux (D-La.) introduced legislation regarding IRAs. Their proposal is more liberal than President Clinton's proposal or the proposal by the House Republicans. Note that it was senators Roth and Breaux who introduced President Clinton's bill (S 2031) in late 1994 in the Senate.

The Roth/Breaux proposal has these features:

1. The spousal limit of $2,250 would be changed to $4,000, and the at-home spouse could contribute $2,000 to their own IRA and would not need their spouse to make this contribution. That is, a $4,000 deduction would be available to a married couple if there was at least $4,000 of compensation.

2. There would be no income limits ($35,000 and $50,000 under current law) which would reduce/limit the amount of the contribution which could be deducted. That is, the fact that a person was an active participant would no longer impact the amount of the IRA deduction. If a person was married, the active participant status of his or her spouse would not affect the other.

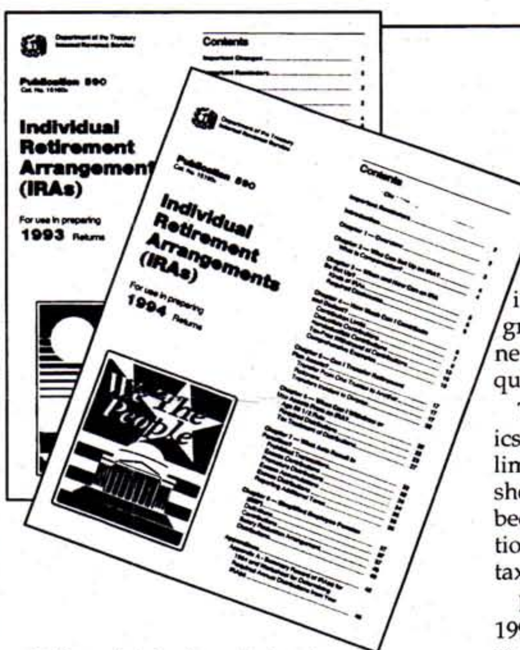
3. The $2,000 contribution limit would be indexed for inflation in increments of $500.

4. A new type of IRA (i.e. back-loaded) would be created. Their term for this new IRA would be "IRA Plus." Under this new type of IRA the contributions would not be deductible but the income would never be taxed if the contributions stayed in the account for a minimum of five years.

5. The 10% excise tax which now applies to most distributions made before the accountholder is age 59 1/2 would not be assessed to distributions from IRAs, TSAs or 401(k)s for extraordinary medical expenses, education expenses and for a first time home purchase.

As with any legislation, we will have to wait and see what happens. PD

Comparison of 1993 and 1994 Publication 590



This article is intended to be a comparison of the two publications, but at times we will summarize the IRS comments to remind you of general IRA rules. The changes are very minimal. The chapters or topics are considered to not have changed if the only difference is in reference to the year. For instance, if an example was given in the 1993 Publication 590 that referenced the year 1993 in the example, and the major difference in the 1994 Publication 590 was to reference the year 1994, these chapters would be considered identical.

Important Changes. The 1993 publication discussed the topics that prohibited transaction exemptions had been granted for certain transactions and that new rules applied to distributions from qualified plans.

The 1994 publication discusses the topics of the new $150,000 SEP compensation limit and the revised deduction worksheets for social security recipients, because the new tax law increases the portion of social security benefits which are taxable.

Important Reminders. The copy for the 1993 and the 1994 issues are identical. The comment is made that the interest earned by an IRA is generally not taxed in the year earned. The interest is tax deferred, not tax exempt, and should not be listed on the tax return as tax exempt.

There is also a reminder that a $50 penalty may apply if one fails to file the Form 8606 to report nondeductible contributions.

Introduction. The two introductions are identical except the 1994 version has a provision for telephone help for hearing-impaired persons.

Chapter 1. Overview. The 1993 and 1994 publications are identical. The IRS states that there are four types of IRAs: (1) IRA accounts; (2) IRA annuities; (3) an IRA established pursuant to an employer, labor union or other employee association; or (4) an IRA established pursuant to a SEP.

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Chapter 2. Who Can Set Up An IRA? The 1993 and 1994 publications are identical. Both state that a person can set up and make contributions to an IRA if he or she has received taxable compensation during the year and has not reached age 70 1/2 by the end of the year. Neither one discusses establishing an IRA with a rollover or a transfer contribution.

Chapter 3. When and How Can an IRA Be Set Up? The 1993 and 1994 publications are identical. For informational purposes we have set forth the section concerned with "inherited IRAs." Note: If a surviving spouse fails to take a RMD, then he or she is deemed to have treated the account as his or her own.

Inherited IRAs: If you as beneficiary, inherit an IRA, that IRA becomes subject to special rules. An IRA you inherit from an owner who died after October 22, 1986, will be included in the estate of the decedent and, unless you are the decedent's surviving spouse, you cannot treat it as your own. This means that, unless you are the surviving spouse, you cannot make contributions (including rollover contributions) to the IRA and you cannot roll it over. But, like the original owner, you generally will not owe tax on the assets in the IRA until you receive distributions from it.

If you are a surviving spouse, you can elect to treat an inherited IRA as your own. You will be treated as having made this election if you:

- Make contributions (including rollover contributions) to the inherited IRA, or
- Do not make required distributions from it.

For more information, see the discussions of inherited IRAs in Chapter 5 and 6 and the discussion of distributions to beneficiaries in Chapter 6.

Chapter 4. How Much Can I Contribute and Deduct? There are some minor differences. The 1994 issue contains additional provisions presumably intended to clarify the discussion. Under the contribution limit section, there is a note which says the standard contribution limit as being the lesser of 100% of compensation or $2,000 must be reduced by any contributions to a 501(c)(18) plan (generally, a plan created before June 25, 1959, funded entirely by employer contributions). Under the section discussing less than maximum contributions, a sentence has been added which states that a person can apply an excess contribution in one year to a later year, if the contributions for the later year are less than the maximum allowed for that year.

Chapter 5. Can I Transfer Retirement Plan Assets? Again, there are some minor differences between the 1993 and the 1994 issue. Under the section dealing with no tax withheld, there is a sentence added which says that since most distributions are fully taxable, payers will generally withhold 20% of the entire amount designated for distribution. There is a rollover example dealing with the receipt of cash and nonemployer stock. The 1994 issue has added a note which says that special rules may apply to distributions of employer securities. For more information, get Publication 575. In the section dealing with transfers incident to a divorce, the IRS reverses the change it made last year. The 1993 issue stated that there are three methods which can be used to make the transfer:

(1) Changing the name on the IRA;

(2) making a direct transfer of IRA assets; and

(3) making a rollover of IRA assets. The 1994 issue says that there are only two methods — the first two methods. Thus, the rollover method is no longer available. Apparently the IRS agrees that the rollover method never should have been mentioned.

Chapter 6. When Can I Withdraw or Use Assets From an IRA? Again, the provisions of the 1994 issue is virtually identical to the 1993 with the following exceptions. When a person has more than one beneficiary, and all are individuals, the statement is made that the beneficiary with the shortest life expectancy will be the designated beneficiary used to determine the period over which your withdrawals must be made. A new sentence is added, "also, see the Minimum Distribution Incidental Benefit Requirement (MDIB Requirement) later." In the section dealing with figuring the minimum distribution, a paragraph has been added to the 1994 issue discussing the figuring of the subsequent year distributions.

Chapter 7. What Acts Result In Penalties? The 1994 issue contains the following two paragraphs which were not in the 1993 issue. "Excise Taxes. If someone other than the owner or beneficiary of an IRA engages in a prohibited transaction, that person may be liable for certain excise taxes. In general, there is a 5% tax on the amount of the prohibited transaction, and a 100% additional tax if the transaction is not corrected. If the IRA ceases to be an IRA because of a prohibited transaction by you (or your beneficiary), you (or your beneficiary) are not liable for these excise taxes. However, you (or your beneficiary) may have to pay other taxes as discussed above under Effect on You (or Your Beneficiary)." It appears that the IRS has taken the position that an IRA custodian/trustee who causes the prohibited transaction will be subject to the 5% and 100% taxes.

Chapter 8. Simplified Employee Pension (SEP). That section which defines who is a highly compensated employee has been updated to list the 1994 dollar amounts rather than the 1993 amounts. The 1994 definition is as follows: A highly compensated employee is an employee who during the year or preceding year:

(1) Owns more than 5% of the capital or profits interest in the employer (if not a corporation); or more than 5% of the outstanding stock or more than 5% of the total voting power of all stock of the employer corporation;

(2) Received annual compensation from the employer of more that $99,000;

(3) Received annual compensation from the employer of more than $66,000 and was a member of the top-paid group (20%) of employees during the year; or

(4) Is an officer whose annual compensation exceeds $59,400.

The 1994 issue contains a new discussion and example of how to calculate the maximum deduction for contributions to a self-employed person SEP-IRA. Under the discussion of a Salary Reduction Arrangement there is a special note which states that for collectively bargained SEPs, the $150,000 limit is not effective for the plan year beginning in 1994, and the compensation limit for such a plan for 1994 is $242,280.

Appendices. It is in this section where there are the most changes with respect to the 1993 and 1994 publications. This is because of the law change affecting the taxation of social security benefits. Worksheet 1 — Computation of Modified AGI (For Use Only By Taxpayers Who Receive Social Security Benefits). The 1993 worksheet had 11 steps. The 1994 version has 19 steps: Worksheet 2 — Computation of IRA Deduction (For Use Only By Taxpayers Who Receive Social Security Benefits). This worksheet is essentially the same for 1993 and 1994. Worksheet 3 — Computation of Taxable Social Security Benefits (For Use By Taxpayers Who Receive Social Security Benefits and Take An IRA Deduction). The 1993 worksheet had 9 steps, and the 1994 version has 19 steps. PD

Summary of Recent IRS Actions

• The IRS has issued revised Form 5310, Application for Determination Upon Termination. It shows a revision date of 7/94.

• The IRS has issued revised Form 5310A, Notice of Plan Merger or Consolidation, Spinoff, or Transfer of Plan Assets or Liabilities; Notice of Qualified Separate Lines of Business. The IRS has said that the current form may be used only until 3/1/95.

• The IRS has issued final "amended" regulations with respect to 401(k) plans. The 401(k) regulations were finalized in 1991 and were amended in 1993 and are now amended again.

• The IRS has now issued the 1994 Form 5500EZ and 5500-C/R forms and related schedules. A copy of 1994 Schedule P will be included with the February newsletter.

• The IRS has issued a temporary and a proposed regulation with respect to the net worth requirements for a nonbank trustee. Under the temporary regulations, the IRS has increased the initial net worth requirement to $250,000 for the most recent taxable year preceding an applicant's application. The old rule had required an initial net worth equal to the greater of $100,000 or 4% of all assets held in fiduciary accounts. Special rules apply to certain passive trustees who are broker dealers regulated by the Securities and Exchange Commission.

• The IRS has issued a new mortality table via IRS Revenue Ruling 95-6, Applicable Mortality Table to be Used Under IRS Sections 415 and 416 as amended by GATT.

• The IRS has issued Revenue Procedure 95-12, Implementing Extensions of Certain Employee Plan Adoption and Submission Deadlines. This Rev. Proc. discusses the past IRS rulings about the extended deadlines for TRA 86. It adopts the extension deadlines as set forth in IRS Announcement 94-136. It also modifies Rev. Proc. 94-13 and changes the deadline for making the changes required by OBRA 1993 from December 31, 1994 to the later of the last day of the 1994 plan year or the time prescribed by law (including extensions) for filing the income tax return (or partnership return of income) for the employer's tax year that incudes the first day of the 1994 plan year.

• The IRS has issued a field directive clarifying the remedial amendment period under IRC section 401(b).

• The IRS has issued Revenue Procedure 95-4, Revised Procedures for Issuing Ruling and Information Letters on Employee Plan Matters. This procedure contains the procedures to be used for such requests in 1995.

• The IRS has issued Revenue Procedure 95-5, Revised Procedures Form Providing Technical Advice regarding Issues in Employee Plans, Exempt Organization Areas. This procedure is primarily used internally within the IRS.

• The IRS has issued Revenue Procedure 95-6, Revised Procedures of Issuing Determination Letters on Qualified Status of Employee Plans. This procedure sets forth what needs to be done to make a determination letter request in 1995.

• The IRS has issued Revenue Procedure 95-8 which sets forth the filing fee amounts which apply for filings in 1995.

• The IRS has issued Publication 590 to be used to prepare 1994 income tax returns. (Individual Retirement Accounts)

• The IRS has issued Publication 560 to be used to prepare 1994 income tax returns. (Retirement Plans for the Self-Employed) PD

IRS Administrative Practice — Disqualification and Fining QP Plans

The IRS has changed its administrative approach drastically within the past three to four years with respect to disqualifying qualified plans which for some reason fail to be "qualified."

Because of the hardship imposed upon all plan participants, the IRS, prior to 1993, rarely would in real life "disqualify" a plan and impose the harsh tax consequences which follow. The IRS would be nice and ask for retroactive corrections which would give the harmed individuals what they should have received (increased contribution or earnings) or it would require the plan to be amended to conform with the law.

The IRS is not so lenient any more. The IRS has created basically four levels of plan errors and administrative responses.

Level #1. The error is so minor the IRS will only ask that the error be corrected, but it will not ask for any money to be paid. The name which the IRS has given this level is "Administrative Policy Regarding Sanctions (APRS)." All of the following criteria need to be satisfied:

1. The operational violation must be an isolated insignificant instance.

2. The plan must have either a history of compliance with Section 401(a) or the violation must have been corrected before examination and there must be no evidence of noncompliance in other areas.

3. The plan sponsor must have established practices and procedures to ensure compliance in the future.

4. Established procedures must have been followed, but through an oversight or mistake in applying those procedures, an operational violation occurred.

5. The dollar amounts involved must be insubstantial in view of the total facts of the case.

6. Once discovered, there must have been immediate and complete correction to cure the violation.

Level #2. The error is one which can be resolved by using the Voluntary Compliance Program as set forth now in Revenue Procedure 94-62. This program provides for continued qualification, correction, and payment of a fixed compliance fee as based upon plan size: (1) $500 if assets less than $500,000 and no more than 1,000 participants; (2) $1,250 if assets of at least $500,000 but no more than 1,000 participants; (3) $5,000 if more than 1,000 participants but less than 10,000 participants; and (4) $10,000 for plans with more than 10,000 participants. The IRS does not assess any fine or sanction for the plan error. The IRS has also created a "standardized VCR" program for very limited situations, and in this case the payment amount is $350.

Level #3 is comprised of those errors which would need to be resolved by use of the Closing Agreement Program or the Walk-In CAP Program. The CAP program applies when a plan is not eligible for APRS or VCR/SVCR. The IRS will allow for the plan to retain its qualification if there is a correction and there is the payment of a "reduced sanction amount." The IRS has indicated that the sanction payment shall be somewhere between 1% and 40% of the amount of tax the IRS would have realized had the plan been disqualified — the sum of: (1) the taxation of the distributions to the participants, (2) the increased tax owed by the employer as a result of disallowing deduction for the contribution and (3) the income tax which would be owed by the nonqualified trust.

Level #4. The errors are so bad that the IRS feels it must disqualify the plan. For example, the IRS would disqualify a plan if loans are given only to the owners of the business in contradiction to a plan provision requiring that all participants be eligible for loans. This instance would lead to disqualification because the plan does not work for the benefit of all participants. Disqualification results in harsh tax consequences.

If a plan sponsor is aware of a defect and does not move to correct it via VCR or CAP, the IRS most likely will "disqualify" the plan. The IRS strongly suggests that plan administrators take advantage of the VCR and CAP programs. PD

GATT and Retirement Plans

It may surprise many people to learn that when Congress passed GATT (General Agreement on Tariffs and Trade), provisions affecting retirement plans were added to the legislation. This article will summarize the provisions that will affect the majority of retirement plans.

The first provision with a major impact is really a provision that preserves the status quo. The legislation extended the period of time the IRS can assess various user fees. The user fee program has been extended five years. These fees generally apply when filing for opinion or determination letters for prototype documents.

A second major part of the pension legislation deals with the rules for cost-of-living adjustments (COLA) to various dollar limits in connection with retirement plans. The new rules deal with how cost-of-living adjustments will be rounded. Rounding COLAs is a new concept in and of itself. Salary deferral amounts will not be adjusted in $500 increments only. This means that until the cost-of-living adjustment exceeds $500, the current levels will not change. In 1995, the COLA did not rise by at least $500. The result is that the maximum salary deferral amount for an individual in 1995 remains at $9,240. The next time it is raised, it will go to $9,500.

The defined contribution plan annual addition maximum is $30,000. This maximum is tied to the defined benefit plan dollar limit. The $30,000 level will not increase until the defined benefit plan dollar limit exceeds $120,000. The defined benefit level COLA adjustment will now be indexed in $5,000 increments. As such, the $30,000 defined contribution plan maximum has not changed.

The last indexing change that was addressed is in the SEP area. The minimum compensation for SEP participation will now be indexed in increments of $50. For 1995, the level then will be $400. PD

IRS Announces Cost-of-Living Adjustments

Unlike IRAs, whose contribution and deductibility limits have remained static through the years, many other retirement plans have a mechanism by which contributions, caps and employee compensation amounts change from year to year. This mechanism is known as indexing.

The IRS in News Release 94-117 has released its 1995 adjustments as follows:

	1993	1994	1995
Elective (Salary) Deferral Limit	$8,994	$9,240	$9,240
SEP Minimum Compensation Threshold	$385	$396	$400
SEP and Qualified Plan Maximum Compensation Cap * – Reduced by Omnibus Budget Reconciliation Act of 1993.	$235,940	*$150,000	$150,000
Section 415			
Defined Benefit Limit	$115,641	$118,800	$120,000
Defined Contribution Limit (The annual defined contribution plan limit is $30,000 as indexed and will not change until the defined benefit amount exceeds $120,000.)	$30,000	$30,000	$30,000
Excess Distribution Tax Threshold	$144,551	$148,500	$150,000
Top-Heavy Plans			
Officer Amount	$57,821	$59,400	$60,000
Top 10 Owner Group (Has more than one-half percent and the largest ownership interest and income in excess of $30,000.)	$30,000	$30,000	$30,000
1% Owner (Having annual compensation in excess of $150,000.)	$150,000	$150,000	$150,000
Highly-Compensated Employees (Compensation as indexed)			
Compensation in excess of $75,000	$96,368	$99,000	$100,000
Compensation in excess of $50,000 and was in the top-paid group	$64,245	$66,000	$66,000

✔✔✔ Check It Out ✔✔✔

Question: When an IRA beneficiary has money paid to him or her from an inherited IRA account, should the Form 1099-R be prepared listing the payee as "Sally Smith as beneficiary of the IRA of John Smith" or to "Sally Smith"?

✔ Answer. Although the IRS instructions do not state this as a requirement, the Form 1099-R should be titled "Sally Smith as the beneficiary of the IRA of John Smith." The reason - for income tax reasons she needs to handle separately her own personal IRA from each and every inherited account. Each of these accounts may have their own nondeductible contribution account basis.

Question: We have a person who is the sole beneficiary of her father's profit sharing Keogh plan. Because he died when he was 62, she has elected to use the five-year rule to withdraw these inherited Keogh funds. When she takes a distribution will it (or any future distribution) be subject to mandatory 20% withholding?

✔ Answer.No, any payment to a nonspouse beneficiary is not eligible to be rolled over and thus is not subject to the mandatory 20% withholding rule. You would need to withhold using either the wage tables or at the rate of 10% unless she instructs you that she does not want withholding or she wants more withheld. PD

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.