THE Pension Digest

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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 The $5,000 death-benefit exclusion would be repealed.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 The ability to use five-year income averaging for lump-sum distributions would be repealed.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 The requirement that at least 50% of the eligible employees must actually participate will be repealed.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 nonhighly-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 attrac-

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tive to many small businesses who had concluded that the high administrative costs did not justify the tax benefits. The tax benefits will now justify the higher administrative costs. This provision will be a real boon to actuaries who provide services to such defined-benefit plans.

13. Current law for a defined-benefit plan mandates a "waiting" period of at least 30 days between when the plan administrator must furnish the required explanation of the Qualified Joint and Survivor Annuity. The new law will state that this 30-day waiting period need not be complied with if waived by the participant and his or her spouse, if applicable. The IRS recently adopted a regulation which would also allow for a shorter time period.

14. Code section 403(b) will be changed to permit a person to have multiple salary-reduction agreements.

15. There are a number of changes with respect to 401(k) plans.

The ADP and the ACP tests would be performed by comparing the average ADP/ACP of the highly-compensated employees to the preceding year's average ADP/ACP of the nonhighly-compensated employees. In the case of the first plan year, the ADP/ACP of the nonhighly-compensated employees for the previous year is deemed to be 3%, or at the election of the employer, the actual ADP for such first plan year.

There will be safe-harbor rules for the ADP/ACP tests. An employer will have the choice of whether or not it wishes to adopt such safe harbors. Many employers will find it advantageous to adopt such safe harbors. These safe harbors will permit a plan to satisfy the special nondiscrimination tests through plan design rather than through the testing of actual contributions.

A plan will be treated as complying (i.e. a safe harbor) with the ADP rules if the plan meets a notice requirement and also meets one or two contribution requirements.

To meet the notice requirement, the employer will need to furnish a written notice to each eligible employee, within a reasonable amount of time before the year of deferral, explaining the employee's rights and obligations under the plan.

The first contribution requirement is that the employer would make a qualified nonelective contribution of at least 3% of each nonhighly-compensated employee's compensation for each nonhighly-compensated employee who is eligible to make an elective deferral.

The second contribution requirement is that for each nonhighly-compensated employee the employer must make a qualified matching contribution which complies with the following rules:

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 noncompliance 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 contribution 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.

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Committee's Report on Law Changes

"Example —Assume that an employer maintains a qualified cash or deferred arrangement under section 401(k). Assume further that the actual deferral percentage (ADP) for the eligible nonhighly-compensated employees is 2 percent. In addition, assume the following facts with respect to the eligible highly-compensated employees:

Employees	Compensation	Deferral	Deferral (percent)
A......................	$200,000	$7,000	3.5
B......................	200,000	7,000	3.5
C	70,000	7,000	10.0
D	70,000	5,250	7.5
E......................	70,000	2,100	3.0
F......................	70,000	1,750	2.5

Under these facts, the highly-compensated employees' ADP is 5 percent, which fails to satisfy the special nondiscrimination requirements.

Under present law, the highly-compensated employees with the highest deferral percentages would have their deferrals reduced until the ADP of the highly-compensated employees if 4 percent. Accordingly, C and D would have their deferrals reduced to $4,025 (i.e. a deferral percentage of 5.75 percent). The reduction thus is $2,975 for C and $1,225 for D, for a total reduction of $4,200.

Under the bill, the amount of the total reduction is calculated in the same manner as under present law so that the total reduction remains $4,200. However, this total reduction of $4,200 is allocated to highly-compensated employees based on the employees with the largest contributions. Thus, A, B, and C would each be reduced by $1,400 from $7,000 to $5,600. The ADP test would not be performed again."

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 differences which will need to be resolved in the Conference Committee. IRA Plus accounts would, in general, be subject to the same rules as those which apply to "deductible" IRAs, but there are some additional rules also. 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. If, for example, Mary Jones put $500 into an IRA Plus, she then 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 accountholder 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 or lost over a scale of $10,000 when his or her adjusted 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 couples' 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.

Year	Schedule for Singles	Schedule For Marrieds
1995	$25,000 - $35,000	$40,000 - $50,000
1996	$30,000 - $40,000	$45,000 - $65,000
1997	$35,000 - $45,000	$50,000 - $70,000
1998	$40,000 - $50,000	$55,000 - $75,000
1999	$45,000 - $55,000	$60,000 - $80,000
2000	$50,000 - $60,000	$65,000 - $85,000
2001	$55,000 - $65,000	$70,000 - $90,000
2002	$60,000 - $70,000	$75,000 - $95,000
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. PD

IRS Announces Cost-of-Living Adjustments for 1996

The IRS in News Release 95-57 has released its 1996 adjustments as follows:

	1993	1994	1995	1996
Taxable Wage Base	$57,600	$60,600	$61,200	**$62,700**
SEP and Qualified Plan Maximum Compensation Cap * – Reduced by Omnibus Budget Reconciliation Act of 1993.	$235,940	*$150,000	$150,000	**$150,000**
Excess Distribution Tax Threshold	$144,551	$148,500	$150,000	**$155,000**
Elective (Salary) Deferral Limit - 401(k) & SAR-SEP	$8,994	$9,240	$9,240	**$9,500**
Highly-Compensated Employees (Compensation as indexed)				
Compensation in excess of $75,000	$96,368	$99,000	$100,000	**$100,000**
Compensation in excess of $50,000/Top Paid Group	$64,245	$66,000	$66,000	**$66,000**
Defined Benefit Limit – Section 415(b)	$115,641	$118,800	$120,000	**$120,000**
Defined Contribution Limit – Section 415(c) (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	**$30,000**
SEP Minimum Compensation Threshold	$385	$396	$400	**$400**
Officer Amount – Top Heavy	$57,821	$59,400	$60,000	**$60,000**
Top 10 Owner Group – Top Heavy (Has more than one-half percent and the largest ownership interest and income in excess of $30,000.)	$30,000	$30,000	$30,000	**$30,000**
1% Owner – Top Heavy (Having annual compensation in excess of $150,000.)	$150,000	$150,000	$150,000	**$150,000**

PD

✔✔✔ Check It Out ✔✔✔

Question: We have the following question regarding required minimum distributions (RMDs). Davis Combe attained age 70 1/2 and 70 in 1989. His wife, Amelia, was his sole beneficiary as of his required beginning date. Amelia was age 67 in 1989. For RMD purposes, David elected to use the nonrecalculation method (i.e. one-year reduction). In 1992, David changed his beneficiary designation so that Amelia would receive 50% of his IRA and his niece, Molly Harmon, age 45, would receive the other 50%. Amelia died in 1993. In 1994, David changed his beneficiary again by naming his estate as his sole beneficiary. Would you please explain what life-expectancy factor would be used for each year?

✔ Answer.

	Year	Factor	Explanation
1.	1989	22.0	Basic rule that the factor is based upon their ages in 1989.
2.	1990	21.0	Original factor less 1 elapsed year.
3.	1991	20.0	Original factor less 2 elapsed years.
4.	1992	19.0	Original factor less 3 elapsed years. Because the niece, Molly, was younger than Amelia, the schedule will not change for subsequent years. The MDIB factor will not be used for Molly's share since Amelia is older than Molly.
5.	1993	18.0	Original factor less 4 elapsed years. Because of Q/A E-5(c)(2) of the proposed regulation, the joint life/one-year reduction schedule is continued to be used for subsequent years even though Amelia died. This section is set forth below: "*(2) If the designated beneficiary whose life expectancy is being used to calculate the distribution period dies on or after the applicable date, <u>such beneficiary's remaining life expectancy will be used to determine the distribution period whether or not a beneficiary with a shorter life expectancy receives the benefits.</u> However, in accordance with E-8, if the designated beneficiary is the employee's spouse, the spouse's life expectancy is being recalculated, and the spouse dies, the spouse does not have any remaining life expectancy; therefore, in the calendar year following the spouse's death, the spouse's life expectancy will be reduced to zero.*" *(emphasis added)*
6.	1994	17.0	Original factor less 5 elapsed years. Again, regulation E-5(c)(2) applies so that the original joint life-expectancy factor will continue to be used for subsequent years even though he has now named his estate as his beneficiary.
7.	1995	16.0	Original factor less 6 elapsed years.
8.	1996 & Subsequent Yrs.		Would continue to use the original schedule as reduced by one for each elapsed year.

Question: If, in the situation outlined in the first question, Amelia had not died in 1993 and David named his estate as his sole beneficiary in 1994, what would the result of that be?

✔ Answer. The factor to be used in year 1989 to 1994 would be the same. The factor for 1995 and subsequent years would be different. In 1994 David named his estate as his beneficiary. Q/A 5(c)(2) contains the following rule:

(2) If a new beneficiary who is not an individual, is <u>added or replaces a designated beneficiary after the applicable date</u>, unless otherwise provided in D-5 and D-6, the employee will be treated as not having designated a beneficiary. Further, except as provided in paragraph (e)(2) in the case of the death of a designated beneficiary, if <u>at any point in time after the applicable date there is no beneficiary designated with respect to the employee, the employee will also be treated as not having a designated beneficiary</u>. In either case, the <u>new distribution</u> period described in subparagraph (1) will <u>equal</u> the <u>period which should have been the employee's remaining life expectancy if no beneficiary had been designated as of the applicable date.</u>" (emphasis added)

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. PD

The Pension Digest invites your questions and comments.
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Law Changes - House—*Continued from page 2*

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. PD