THE Pension Digest

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NEW LEGISLATION PASSED – SIMPLEs & MSAs DISCUSSED

The SIMPLE Retirement Plan and Accounts

The Small Business Job Protection Act of 1996 creates a new type of employer-sponsored pension plan called, "Savings Incentive Match Plans for Employees of Small Employers" (SIMPLE). This article summarizes the attributes of the SIMPLE. Businesses (employers) will be able to establish a SIMPLE on or after January 1, 1997, because the tax law is effective for tax years beginning after December 31, 1996.

Your financial institution will need to decide what services, if any, you wish to render with respect to a SIMPLE plan and a SIMPLE-IRA (Simple Retirement Accounts). The SIMPLE is like a SEP (Simplified Employee Pension) in the sense that the funding vehicle for the plan will normally be a special type of IRA, a SIMPLE-IRA. As discussed immediately below, special rules govern the SIMPLE-IRA versus the regular IRA. A distribution from a SIMPLE-IRA during the two-year period beginning on the date an individual first participated is subject to a 25% excise tax and not the 10% excise tax. A simple retirement account is not eligible to be rolled over unless the rollover is to another SIMPLE retirement account. Also, a SIMPLE retirement account will be able to be rolled to a regular IRA once the person is no longer subject to the 25% excise tax.

What Businesses May Establish a SIMPLE?

To be eligible to have a SIMPLE, an employer must meet two requirements. First, an employer will be eligible if it employed 100 or fewer employees on any day during the preceding year and the employees received at least $5,000 in compensation.

Obviously, a one-person business has less than 100 employees. The law does expressly define the term "employee" to include a self-employed individual. Thus, it appears that farmers and ranchers and other sole proprietors will be able to have a SIMPLE, and they are going to like this new plan if their annual contributions are normally less than $6,000. As discussed below, a self-employed person under a SIMPLE is not limited to deferring (i.e. contributing) 15% or 25% of net earnings as with a profit sharing or money purchase plan.

There is also a two-year grace period created for an employer who established a SIMPLE when eligible but who becomes ineligible because the number of employees exceeds 100. This two-year grace period will be granted in the case of an acquisition, disposition, or similar transaction which causes the ineligibility unless certain special rules would be met.

Second, the employer (or any predecessor employer) cannot currently maintain another Qualified Plan. For these purposes, a Qualified Plan includes a qualified retirement plan, a qualified annuity plan, a governmental plan, a tax-sheltered annuity, and a SEP. Technically, the employer cannot have maintained a retirement plan with respect to which contributions were made or benefits were accrued, for service in any year in the period beginning with the first year the SIMPLE becomes effective, and ending with the year for which the determination is being made.

What is the Basic Concept of the SIMPLE Retirement Plan?

A SIMPLE is a simplified version of a 401(k) plan or salary-reduction SEP plan. The basic concept is that an employee/participant will be eligible to contribute his/her own funds from his/her payroll or bonus, and that the employer will make matching contributions. Limits exist as to how much the employee may contribute (i.e. electively defer), and there are limits as to the matching contribution the employer must make.

An employee who is eligible to participate in the SIMPLE may elect to have the employer pay him or her in cash or to have the employer make an elective employer contribution to a SIMPLE retirement account on behalf of the employee.

A simple retirement account is an IRA which meets special rules set forth in a new Code section 408(p). Alternatively, the employer may change its 401(k) plan to comply with the special SIMPLE rules.

The SIMPLE is a Calendar-Year Plan

An employee may elect to defer an amount not to exceed $6,000 per year. Note that this amount is approximately 2/3 of what is currently permitted under a 401(k) plan or a salary-reduction SEP plan — $9,500. The amount which an employee defers must be expressed as a percentage of compensation. However, there is no limit with respect to this percentage. It can be greater than 15% or 25%; in fact, it could be 100%. The employer must match on a dollar for dollar basis what the employee has chosen to electively defer, up to 3% (or the applicable lesser percentage) of the employee's compensation. There is a special rule as discussed later which allows an employer to set its match at less than 3% (but not less than 1%) if certain rules are met.

Thus, if an employer makes an elective deferral, the employer must make a matching contribution except as discussed later. For purposes of the elective deferral and the employer's matching contribution, an employee's total compensation may be considered. That is, an employee's compensation is not capped at $150,000.

Example #1. Mark Kinsey has compensation of $28,000. He could elect to defer $6,000 if he could afford it. He would do this by furnishing an instruction that he wanted 21.43% electively deferred. The employer then would be required to make a matching contribution of $840.

Example #2. Michelle Battle has compensation of $300,000. She could elect to defer $6,000 — she can afford it. She would do this by furnishing an instruction that she wanted 2.0% of her compensation electively deferred. The employer would then be required to make a matching contribution of

Continued on page 2

Also in this issue –

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SIMPLE—*Continued from page 1*

$6,000. The employer must match up to 3% of compensation. Thus, Michelle will receive a total contribution amount of $12,000.

The $6,000 amount will be adjusted periodically for cost-of-living increases.

A SIMPLE does not permit an employer to make any other type of contributions. An employer is not permitted to make a pro rata contribution (e.g. 8% of compensation) to the eligible employees as permitted with a standard profit sharing plan or a SEP plan.

What Employees Must an Employer Cover in Order to Have a SIMPLE?

In essence, a SIMPLE has a two-year participation requirement. Any employee who was paid at least $5,000 in compensation during each of the preceding two years, and who is reasonably expected to receive at least $5,000 in compensation during the "upcoming" year, must be eligible to participate in the SIMPLE for the upcoming year. Note that under this plan it is the amount of compensation which will determine eligibility and not hours of service. Thus, under a SIMPLE, an employee must be eligible to make his or her elective deferrals and also to receive the mandatory employer matching contribution. An employer will be able to choose to exclude nonresident aliens and employees covered under a collective-bargaining agreement. Compensation for an employee is defined to be the sum of his or her Form W-2 compensation plus any elective deferral amount. Self-employed individuals can participate in a SIMPLE. Compensation for a self-employed individual is defined to be his or her net earnings without regard to any contribution under the SIMPLE.

What Administrative Rules will Apply to the Elective Deferrals?

An employee will use the 60-day period before the start of any year to decide if he or she will make elective deferrals during the upcoming year, or change prior instructions. For example, if the next plan year will be January 1, 1997, to December 31, 1997, then the employees will be able to decide what elections they will make between November 2, 1996, and December 31, 1996.

A plan may be permitted to be written to allow a participant to increase or decrease his or her deferral instruction during the year, but the plan need not permit this. However, a participant must have the right to stop his or her elective deferrals at any time. Once a participant stops his or her elective deferrals, the plan may be written to not allow elective deferrals to start again until the next year.

The employer is required to contribute an employee's elective deferrals to his or her SIMPLE-IRA within 30 days after the end of the month to which the contributions relate.

The employer is required to contribute its matching contributions no later than its tax filing deadline for such year, including extensions, if applicable.

The employer may make all contributions under the SIMPLE to the IRAs of a designated trustee or issuer. This right exists only if each participant is informed in writing that he or she may transfer or roll over his or her account without cost or penalty to another SIMPLE-IRA or regular IRA when eligible to do so.

When May an Employer Make a Matching Contribution of Less Than 3%?

An employer may set its matching rate at as little as 1% of compensation if two requirements are met. First, the employer must notify the employees of the lower percentage within a reasonable amount of time before the 60-day "decision" period commences. Second, during any five-year period, the actual annual percentage of the employer's match cannot be less than 3% for more than two of the five years considered in the calculation (current-year plus previous four years). That is, an employer is required to set its matching rate at 3% for at least 3 years during any five-year period. A special rule covers the situation for those years before the employer sponsored the plan. If the SIMPLE was not in existence for all or any part of the five-year time period, then the employer is allowed to proceed as if its matching rate had been 3% for such years. For example, the employer's matching rate may be 1% for each of the first two years. If the employer did this, the matching rate would have to be 3% for years 3, 4 and 5. Or, if the employer had set its match at 1% for year 1, 3% for year 2, 3% for year 3, and 1% for year 4, then the percent for year 5 must be 3% because there are two prior years where the percentage was set less than 3%.

May the Employer Avoid Making a Matching Contribution by Making a 2% Nonelective Contribution?

Yes. An employer is not required to make a matching contribution if the employer elects to make a nonelective contribution of 2% of compensation for each employee who is eligible to participate in the SIMPLE-IRA and who has at least $5,000 of compensation for the current year. The employer must notify the employees that it will be making this 2% contribution rather than the matching contribution within a reasonable amount of time before the 60-day employer election period. Compensation is limited to $150,000 for purposes of this 2% nonelective contribution.

What is the Tax Treatment of Contributions?

Contributions to a SIMPLE are excludable from the gross income of the employee.

The employer will be able to deduct both its elective deferral contributions and its matching contributions. The employer is entitled to deduct such contributions in its taxable year within which the calendar year for which the contributions were made ends.

An employer may make the matching contributions after the end of the year if they are made on account of such taxable year and are made not later than the time prescribed by law for filing the return for such year (including extensions). The employee's elective contributions are to be treated as wages for employment tax purposes. That is, these elective deferrals will be subject to social security and medicare taxes. The employers matching contribution will not be subject to such taxes.

The income earned by the contributions will not be taxed until a distribution occurs. An employee is always 100% vested in any contribution to the SIMPLE account. An employee who makes an elective contribution to a SIMPLE account will be an active participant for IRA deduction purposes. The top heavy rules do not apply to a SIMPLE account plan.

What is the Tax Treatment of Distributions?

Distributions will be taxed under the rules generally applicable to IRAs. Distributions prior to age 59 1/2 will generally be subject to the 10% excise tax. However, a 25% tax will be imposed rather than the 10% tax if there is a withdrawal of contributions within the two-year period commencing on an employee's participation in the SIMPLE.

Funds within a SIMPLE-IRA will be eligible to be rolled over to an IRA once the participant has satisfied a two-year participation requirement in the SIMPLE. Otherwise, funds within a SIMPLE-IRA can only be rolled over to another SIMPLE-IRA.

What Reports Will the Trustee (i.e. the Financial Institution) be Required to Prepare to Comply With IRS and ERISA Rules?

At least once a year the trustee must furnish a report to the IRS. The contents of this report are not all that clear. The IRS will need to furnish guidance. Presumably the contents of what is furnished to the IRS will be very similar to the information which must be given to the participant.

Within 30 days after the end of each calendar year (i.e. January 30th), the trustee must furnish each participant a statement showing the SIMPLE account balance as of December 31 of such year and the activity for such account during the calendar year.

The trustee must furnish the sponsoring employer a summary description which must contain the following information:

A. The name and address of the sponsoring employer;

B. The name and address of the trustee;

C. The requirements for eligibility for participation;

D. The benefits provided under the plan;

E. The procedures to be used (i.e. time

Continued on page 3

SIMPLE—*Continued from page 2*

and method) to make salary-reduction elections;

F. The procedures and effects of withdrawing funds from the SIMPLE; and

G. The procedures and effects of making a withdrawal for rollover purposes.

A trustee who fails to furnish one or more required summary descriptions or statements in a timely fashion will be subject to a penalty of $50 for each day for which such failure or failures continue unless the failure is due to a reasonable cause. Note that the fine is not $50 per account. It is per day for one or more required failures. So, it will apply if you happen to miss just one account.

What Reports Must the Employer Prepare for the Employees, the IRS and for ERISA Purposes?

The employer must notify each employee of his or her eligibility to make elective deferrals immediately before the employee becomes eligible to make the election. That is, the employer must give notice to the employee just before the 60-day election period commences. The employer's notice must contain a copy of the notice furnished by the trustee. The employer is subject to a fine of $50 per day if it fails to furnish this notice unless there is a reasonable cause for the failure.

How Will ERISA Apply to a SIMPLE Retirement Account?

Only simplified reporting will be required under ERISA. No reports, other than those required under ERISA section 101(9) shall be required. Thus, there should be no Form 5500 or any similar form to be completed.

An employer who sponsors a SIMPLE will not be subject to any fiduciary liability when the employee or a beneficiary exercises control over the assets in his or her own SIMPLE account. Control exists upon the earlier of (1) an affirmative election with respect to the initial investment of any contributions, (2) a rollover contribution to another SIMPLE account or IRA (including a trustee-to-trustee transfer); or (3) one year after the SIMPLE is established.

How Will the SIMPLE Rules Apply to a 401 (k) Plan?

A safe harbor is created for complying with the nondiscrimination requirements which apply to employee elective deferrals and employer matching contributions. That is, there is deemed compliance with the ADP and ACP tests if the safe harbor is satisfied.

The safe harbor is satisfied if, for the year, the employer does not maintain another Qualified Plan, the employee's elective deferrals are limited to no more than $6,000, the employer matches the employee's elective deferrals up to 3% of compensation, and no other types of contributions are made. Under the 401(k), the employer cannot reduce the matching percentage to less than 3%. All contributions under the safe harbor must be 100% vested. A plan meeting the safe harbor is treated as not being top heavy.

The IRS will need to furnish guidance as to how an existing plan can be amended to include the SIMPLE safe harbor.

Conclusion

The law now authorizes a new type of employer-sponsored retirement plan. The IRS needs to issue guidance on whether the SIMPLE will be a prototype program or a model form program. You must first decide if you will offer the SIMPLE plan. You then must decide how you will inform your customers that you have the deposit accounts and administrative services available to assist your business customers.

As with every tax law, SIMPLE does not necessarily mean "simple" because the rules governing any retirement arrangement are somewhat complicated. The SIMPLE is no different. Although the rules are simpler than for a 401(k) plan and other Qualified Plans, it is arguable whether they are simpler than those which apply to salary-reduction SEP plans or SEP plans.

Many owners of small business will like this plan because they will be able to contribute $6,000 for themselves, and they will only be required to put in a maximum of 3% of their employees' compensation. This appears to be a good deal for such owners as compared to present rules. An IRA custodian should be ready to service such small businesses. Businesses with 2 to 100 employees which make monthly contributions will generate substantial annual deposits. PD

THE Pension Digest

Medical Savings Accounts (MSAs)

As many of you are aware, legislation has been passed and signed that directly impacts IRAs and Qualified Plans. Somewhat overlooked by many is a new kind of savings account called Medical Savings Accounts (MSAs). These new types of accounts will come into existence on January 1, 1997. These accounts are designed to encourage employees of small businesses and self-employed individuals who participate in a high-deductible health care plan to save for medical expenses they may face. While a previous article in this newsletter discussed MSAs, the final legislation changed some of the rules governing these accounts. This article will examine how MSAs will work under the new rules.

Who is Eligible for an MSA?

The first point to examine is who will be eligible to establish and maintain an MSA. The rules state that MSAs are available to employees of "small employers" who participate in "high deductible health plans" and who have no other health care coverage. Each of these requirements needs to be examined in order to determine whether or not a person is eligible to contribute to an MSA.

1. Employee of a "Small Employer" — A "small employer" is defined as an employer having employed an average of 50 or fewer employees during either of the two preceding calendar years.

2. Participate in a "High-Deductible Health Plan" — A high-deductible health plan is one that contains certain dollar limits for the plan's deductible and maximum out-of-pocket expenditures. These are shown here.

- Individual Coverage - The minimum deductible is $1,500 and the maximum is $2,250. The maximum out-of-pocket limitation is $3,000.
- Family Coverage - The minimum deductible is $3,000 and the maximum is $4,500. The maximum out-of-pocket limitation is $5,500.
- These amounts will be indexed for inflation after 1998.

3. No Other Health Care Plan Coverage — The person cannot also have another health care plan that is not a high-deductible plan that provides coverage for any benefits that are also provided in the high-deductible plan.

Certain other types of coverage will be permitted. These include Medicare supplemented insurance, insurance related to workers compensation, tort liabilities, and liabilities relating to the ownership or use of property, insurance for a specified disease or illness, and insurance paying a fixed amount per day for hospitalization.

National Limit On MSAs

As the MSAs are currently considered a "test project," the legislation creating them places a limit of 750,000 participants on MSAs. This national cutoff amount is actually phased in. The first reporting on MSAs will be due by June 1, 1997. If at that time there have been 375,000 or more MSAs created, the IRS will announce a cutoff on the establishment of more MSAs on or before September 1, 1997. If this figure has not been reached at that time, there will be no cutoff announced and the number of MSAs will be examined again in the second reporting period. The second reporting period for MSAs is due by August 1, 1997. If 525,000 or more MSAs have been established by that date, a cutoff would once again be announced. In 1998 the cutoff figure will rise to 600,000 and in 1999 to 750,000. Once this figure is reached, no more MSAs can be established until such time as the government decides to expand the program. The IRS will be issuing

Continued on page 4

MSAs—*Continued from page 3*

announcements of when levels of participation prevent more MSAs from being established.

It is important to make one point. Under the MSA rules, a person who established the MSA properly before any IRS announcement of a cutoff will be permitted to continue to fund their MSA.

Tax Benefits & Contribution Amounts

The contribution amounts for which a person may be eligible, and the tax ramifications on distribution are what makes MSAs so attractive. The contribution amounts will be higher in many cases than what we are used to seeing with IRAs. Distributions may escape tax altogether when made for the right reasons. It is our feeling that these tax benefits will attract a great number of potential accountholders. The rules are examined here.

1. Contributions

a. Individual Contributions - An eligible individual will receive a tax deduction for the contribution they make to an MSA. The contribution and deduction is limited to 65% of the annual deductible under the plan for a person with individual coverage and 75% of the annual deductible under the plan for a person who has family coverage.

These amounts must be prorated if the person did not participate in the high-deductible plan for the entire year. The prorating begins with the month of the year that the individual was a participant in the high-deductible plan as of the first day of the month. For example, if the person become a participant in the plan on July 1, 1997, under the family coverage, they could contribute 75% of the annual deductible under the plan times 6/12.

Note that the contribution and deduction amount is a percentage of the plan's deductible and not the out-of-pocket limits.

EXAMPLE - An eligible individual wishes to make a contribution to an MSA. They participated in a health care plan for the entire year with family coverage, a deductible of $4,000, and out-of-pocket expenses limited to $5,000. Their contribution and deduction limit would be $4,000 times 75% or $3,000.

b. Employer Contributions - If an employer makes any MSA contributions for its employees, the individual employees are not permitted to make MSA contributions on their own.

If the employer is making the contributions, they must meet a comparability test. The comparability test requires that the employer either contribute the same amount for each employee or the same percentage of the deductible for each employee. If this test is violated, the employer faces an excise tax of 35% on the aggregate contributions made during the period in which the violation occurred.

Employer contributions must be reported on the individual employee's W-2 but are generally excluded from income by the employee. Earnings on the funds in the account are not included in income in the year earned.

c. Contribution Deadline - The deadline for an MSA contribution is the tax-filing deadline for the year for which the contribution is being made, not including extensions.

2. Distributions

a. General Rule - Distributions made from the MSA will not be subject to tax if they are used to pay qualified medical expenses that are not covered by the health care plan. The distribution can be used to pay the medical expenses of the individual, their spouse, or their dependents as long as no coverage under the health care plan is provided. Qualified medical expenses are medical expenses that would qualify as a deductible item on an individual's 1040 Schedule A as a medical expense. Health insurance may not be purchased with the distribution except for continuation coverage required by federal law, or a health plan purchased while the individual is receiving unemployment compensation.

b. Distributions Not for Medical Purposes - Distributions used for a purpose other than a medical expense will be taxed and will be subject to a 15% penalty tax unless the distribution is made after age 65 or because of death or disability.

3. Rollovers

A person who has an MSA will be permitted to take a distribution and roll over the funds to a different MSA account within 60 days. This is limited to one rollover of MSA funds per 12-month period. Note this is not one rollover per MSA account, but one rollover per 12-month period for all MSAs an individual may maintain.

Documentation and Administrative Requirements

The MSA must have a trustee or a custodian. It can be any entity that meets the requirements of being an IRA custodian or trustee. There must be a written document creating the MSA account. At this time we do not yet know what the document requirement will be other than the fact that a document will be necessary.

The MSA funds cannot be invested in life insurance or commingled with other assets. A person's interest in their MSA is nonforfeitable. The MSA accountholder is permitted to name a beneficiary. In all likelihood, the only beneficiary that it would be wise to name is the spouse. The reason for this is simple. If the spouse is the named MSA beneficiary, at the accountholder's death the rules state that the MSA automatically becomes the MSA of the spouse. If a nonspouse is the beneficiary, on the date of death the MSA ceases to be an MSA and the fair market value on that date becomes taxable income to the nonspouse beneficiary in the year of death.

Reporting

The custodian/trustee of the MSA will have to report the number of MSAs they hold to the IRS. No later than August 1, 1997, 1998, and 1999 they will have to report the following:

- The number of medical savings accounts established before July 1.
- The name and TIN of each MSA accountholder.
- The number of these accounts which are the accounts of previously uninsured individuals.

Additionally, for the first reporting period an additional report is necessary. By June 1, 1997, the same information listed above must be submitted to the IRS for all MSAs established before May 1, 1997.

The rules also state that the Secretary of the Treasury is to establish reporting procedures for reporting contributions to and distributions from an MSA. We would expect some type of reporting for MSAs that is similar to 5498 and 1099-R reporting for IRAs.

Opportunities with MSAs

We feel that the potential for deposits with MSAs is great. With the tax benefits available through these types of plans, individuals who meet the eligibility requirements will find these very attractive. From the viewpoint of the potential custodian/trustees of MSAs, time is critical. As mentioned before, this is considered a test project and a limited number of individuals will have the opportunity to use MSAs. We feel it is important for you to gear up for offering these accounts.

While this is a test project at this time, the potential for opening MSAs up to everyone who meets the eligibility requirements in the near future is very real. Anyone who is already offering and administering these accounts during the test period will have a very large advantage should these be opened up to everyone who qualifies. Sitting back and waiting to see if that happens could cause an institution to miss out on this opportunity. With the similarity these accounts bear to IRAs, your institution is in a good position to offer them.

CWF will have the documents, software and materials you need to administer these accounts. Don't miss this opportunity. Watch future issues of *The Pension Digest* for more discussion of MSAs. As things such as document requirements and reporting issues are clarified, they will be discussed here. PD