THE Pension Digest

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IRA Changes

Our last newsletter discussed two new types of savings accounts that were created by the recent tax legislation — the SIMPLE and the Medical Savings Account (MSA). This article will examine changes the legislation made to the IRA rules and will also discuss IRS revisions to some of the reporting procedures for Form 5498 and Form 1099-R reporting.

Spousal IRA Contribution Changes

This first IRA change examined deals with spousal IRA contributions. The current rules as applicable for the 1996 tax year are discussed first. The rules that go into effect beginning with the 1997 tax year are then addressed.

Current Rule for Spousal Contributions — 1996

The current rules permit a married couple to make total contributions of the lesser of $2,250 or 100% of their earned income to their IRAs when one is working and the other is not. They must file a joint tax return. Neither one of their IRAs can receive a contribution of more than $2,000 for one tax year. The total amount of $2,250 can be split any way they choose between their two IRAs. This is the current rule and remains in effect until 12-31-96. This means this is the spousal contribution rule for the 1996 tax year.

1997 Rule for Spousal Contributions

Beginning on January 1, 1997, for the 1997 tax year, the spousal contribution amount will change. The total contribution permitted in a spousal IRA situation will be the lesser of $4,000 or 100% of their combined earned income. Neither one of their IRAs can receive a contribution of more than $2,000 for the tax year. The couple must file a joint tax return to be eligible for the spousal contribution. The following two examples will illustrate the new rule.

Example 1 - John Smith earns $32,000 in 1997. His wife Joan does not work. They file a joint tax return. They can each contribute $2,000 to an IRA for 1997, for a total of $4,000. This amount is based on the income John received in 1997.

Example 2 - Phil Brown earned $26,000 in 1997. His wife Carrie earned $1,100 in 1997. They file a joint tax return. They can each make a contribution of $2,000 to an IRA for 1997, for a total of $4,000. This is despite the fact that Carrie had earned income of $1,100 of her own. The spousal rules permit the contribution amount for each to be $2,000 as long as the total contribution does not exceed their combined earned income. Since their combined earned income exceeds $4,000, each can contribute $2,000 to their IRA.

New Premature Distribution Exception

General Rule & Current Exception

If an IRA accountholder takes a distribution from their IRA prior to attaining age 59 1/2, the distribution is generally subject to a 10% premature distribution penalty tax. There are certain types of distributions, however, that are exempt from this penalty. Under the current rules, distributions before age 59 1/2 that are not subject to the penalty include a distribution made due to death, to total and permanent disability, and one that is part of a series of substantially equal periodic payments. These remain the only exceptions to the penalty until the end of 1996.

New Exceptions to the 10% Premature Distribution Penalty

Beginning with distributions made after January 1, 1997, a new exception to the 10% premature distribution penalty tax is added. Distributions made for the payment of certain medical expenses and health insurance premiums will be exempt from this tax.

Medical Expenses - A distribution in 1997 will not be subject to the 10% premature distribution tax if it is used to pay medical expenses that exceed 7.5% of the person's adjusted gross income. This means that the medical expense has to qualify as an itemized deduction on the person's IRS Form 1040, Schedule A, in order for an IRA distribution prior to age 59 1/2 to be exempt from the penalty tax.

Health Insurance Premiums - A distribution in 1997 will also not be subject to the 10% premature distribution tax if it is used to pay health insurance premiums after a person has become unemployed. In order to qualify for this exception, the person must have been receiving unemployment benefits for at least 12 consecutive weeks. The distribution must occur in either the year the

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person received the unemployment benefits or during the next tax year. The exception no longer applies to distributions made once a person is reemployed for at least 60 days after the initial separation from service.

This exception also applies to a self-employed individual if that individual would have been eligible for unemployment benefits except for the fact that they were self-employed.

Suspension of the 15% Excise Tax on Excess Distributions

Previous articles in this newsletter have discussed the topic of the 15% excise tax on distributions from an IRA that exceed certain amounts. The basic concept is that any distribution from an IRA that exceeds $155,000 in a year, as indexed, will be subject to ordinary income tax and a penalty tax of 15% on the amount that exceeds $155,000 in the year. This excise tax is suspensed for IRA and qualified plan distributions for the years 1997, 1998, and 1999.

Change to Excess Contribution Withdrawal After Tax Return Due Date

The current rules state that when an excess contribution is withdrawn after the tax return due date for the year, the excess withdrawal will not be taxable if the contribution was not claimed or allowed as a deduction on the tax return, and the total amount contributed for the year by the individual did not exceed $2,250.

This rule has been modified. The new rule is that the excess contribution withdrawal will not be taxable if no deduction was claimed or allowed and the total contribution for the year did not exceed $2,000. This new rule applies for 1997 and subsequent years.

Amendment & Document Issues

Plan Agreement & Written Disclosure

The regulations state that the plan agreement and the written disclosure statement given to an accountholder at the time they establish their IRA must be the most current plan agreement, and the disclosure must explain all the current IRA rules. We do not know at this time whether or not the IRS will be revising their 5305 and 5305-A plan agreements. We do know that the written disclosure portion of the document will have to be updated. As the spousal contribution rules, the rules governing exceptions to the 10% premature distribution tax, the excess contribution withdrawal rules, and the excess distribution rules are changing, the written disclosure statements provided beginning on January 1, 1997, must contain a discussion of these new rules. As a result, at minimum, the documents you use to establish IRAs will have to have updated written disclosures to reflect these new rules. You will have two choices for the documents you use to establish new IRAs beginning on January 1, 1997. Either a complete new document that contains a discussion of the new rules will be necessary beginning on January 1, 1997, or an amendment that contains a discussion of the new rules will have to be given to any new accountholder along with your current plan agreement and written disclosure.

Be aware that if the IRS does revise the 5305 and 5305-A before January 1, 1997, the new plan agreement and written disclosure will, in all likelihood, be required for new accounts established on and after January 1, 1997.

Amendments

The rules also state that existing accountholders need to be informed when the rules change. Their documents must be amended to reflect the changes in the rules. These changes necessitate an amendment to the written disclosure statement existing customers received. It is our recommendation that these amendments be sent to all existing IRA accountholders by January 31, 1997.

NOTE: It is entirely possible that other IRS or legislative changes could necessitate further amendments in 1997. At this time not much is known about what the IRS requirements will be with all the changes. The safest course of action is to provide the amendments by January 31. Alternatively, you could delay amending until later in 1997 to see if further changes are forthcoming.

IRA Reporting Changes

5498 Changes

The 1996 IRS Form 5498 and the reporting rules accompanying this form have changed. There are two significant changes to the 5498 reporting requirements. The first is the addition of a new box to the form, and the second relates to the number of 5498s an institution must file for an accountholder.

Addition of a New Box - A new Box 5 has been added to the 1996 Form 5498. This box contains a SEP check box that is to be marked if this IRA is reporting the fair market value of an IRA that contains SEP contributions. Completion of the box is optional for 1996. It will be mandatory for 1997 reporting.

The Number of 5498s Filed for an Individual - The instructions to the 1996 Form 5498 very explicitly state that a separate 5498 return must be filed for each IRA plan agreement that a person maintains with an institution. This means that if an individual has more than one IRA plan agreement with an institution, the institution will have to generate and file a separate 5498 for each plan agreement maintained. As many computer systems generate reports based on Social Security numbers, this presents a large potential problem. It is not permissible to aggregate all IRA accounts held under one Social Security number onto one 5498. The relevant IRS language is reproduced below.

> "An IRA includes all investments under one IRA plan. It is not necessary to file a Form 5498 for each investment under one plan. For example, if a participant has three CDs under one IRA plan, only one Form 5498 is required for all contributions and the fair market values of the CDs under the plan. However, if an individual has established more than one IRA plan with the same financial organization, a separate Form 5498 must be filed for each plan."

1099-R Changes

The changes to the Form 1099-R reporting rules deal with the specific situation of withdrawing an excess contribution after the due date of the tax return. The 1996 1099-R instructions state that in this situation a Code 1 is used if the person was not yet age 59 1/2, and a Code 7 is used if they are over age 59 1/2. Prior to the 1996 reporting year, the instructions had said to use a Code 8 in this situation.

IRS Announcement 96-88

The IRS issued this announcement on September 16, 1996. Another law change (The Taxpayer Bill of Rights) requires that on certain statements payers (financial institutions) provide the telephone number of a person to contact. The announcement is set forth below.

This announcement does not say the rule applies to the IRA forms (5498 and 1099-R). The IRS encourages IRA custodians to furnish the telephone number on such forms.

It is very likely that this telephone number requirement will also apply to the 1997 Form 5498 and Form 1099-R because these forms are now subject to the penalties under Code section 6722. This change was brought about by the Small Business Job Protection Act.

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Telephone Numbers on Statements — Forms W-2G, 1098, 1099 and 8308 — Penalty Waiver

Announcement 96-88

The Taxpayer Bill of Rights 2 (P.L. 104-168) requires payers to provide the telephone number of a person to contact on certain statements to recipients, generally Copy B of the forms listed below. This number must provide direct access to an individual who can answer questions about the statement. This new requirement applies to the 1996 forms due to recipients by January 31, 1997. Because the legislation was enacted after the 1996 forms were printed, a failure to include a phone number on the 1996 statements will be considered to have arisen from an event beyond the control of the filer. As a result, the penalty under section 6722 of the Internal Revenue Code will be waived for reasonable cause if the next statement required to be provided (generally for 1997) includes the phone number.

Although the penalty will be waived for 1996, payers are encouraged to enter the telephone number anywhere they choose on the recipient statements. The law requires that the information be entered on Forms W-2G, 1098, 1099-A, 1099-B, 1099-DIV, 1099-G (excluding state or local income tax refunds), 1099-INT, 1099-MISC (excluding fishing boat proceeds), 1099-OID, 1099-PATR and 1099-S. However, payers are also encouraged to furnish the telephone number on other Forms 1099. The 1997 revisions of the forms listed above will require that the telephone number be included in the filer name and address area. The telephone number is not required on Copy A of paper forms nor on magnetic media filed with the IRS.

The telephone number also must be provided on Form 8308, Report of a Sale or Exchange of Certain Partnership Interests, required to be furnished after 1996. Form 8308 is being revised accordingly. PD

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Summary of Major Changes to Qualified Plans

The new tax legislation made numerous changes with respect to qualified plans. Plan documents will need to be rewritten, as will numerous administrative forms, including summary plan descriptions.

As a result of this legislation, all existing qualified plans will need to be amended and restated. The law states that this must be done by January 1, 1998. The IRS will be issuing guidelines as to when and how this amending must be done. Most likely, this amending will take place during 1998 so the IRS will be allowing some extension of the January 1, 1998, deadline.

A summary of the law changes is set forth. Keep in mind that the approach of the law will be that the document need not be amended immediately to contain the new rules as long as the plan in operation complies with the new rules and is amended on a retroactive basis.

Many of the changes with respect to 401(k) plans will be liked by those employers who currently sponsor a 401(k) plan. There has been a true attempt to simplify some of the administrative tasks.

Deadline for Amending Plans

The deadline for amending plans is the first day of the plan year beginning on or after January 1, 1998, for nongovernmental plans and annuities. This grace period for the adoption of amendments is available only if: (1) the plan or annuity contract satisfies the new laws in operation after the date on which the plan amendment takes affect and before the first plan year beginning after 1997; and (2) the plan amendment applies retroactively to this period of time dating from the plan amendment's effective date of the first plan year after 1997.

For governmental plans, the deadline is the first plan year beginning on or after January 1, 2000.

Contribution/Aggregation Limit on Owner-Employees is Repealed

Under existing law, in some situations, when an owner-employee has an ownership interest in more than one business, then there are restrictions placed on the contribution which can be made for the owner-employee.

Here is a summary of the current law:

Special Qualification Rules for Owner-Employees –

If this plan provides contributions or benefits for one or more owner-employees who control both the business for which this plan is established and one or more other trades or businesses, this plan and the plan(s) established for the other trades and businesses must, when looked at as a single plan, satisfy Sections 401(a) and (d) for the employees of this and all other trades and businesses.

If the plan provides contributions or benefits for one or more owner-employees who control one or more other trades or businesses, the employees of the other trades or businesses must be included in a plan which satisfies Section 401(a) and (d) and which provides contributions and benefits not less favorable than provided for owner-employees under this plan.

If an individual is covered as an owner-employee under the plans of two or more trades or businesses which are not controlled and the individual controls a trade or business, then the contributions or benefits of the employees under the plan of the trades or businesses which are controlled must be as favorable as those provided for him under the most favorable plan of the trade or business which is not controlled.

An owner-employee, or two or more owner-employees, will be considered to control a trade or business if the owner-employee, or two or more owner-employees together:

Own the entire interest in an unincorporated trade or business, or,

In the case of a partnership, own more than 50 percent of either the capital interest or the profits interest in the partnership.

An owner-employee, or two or more owner-employees shall be treated as owning any interest in a partnership which is owned, directly or indirectly, by a partnership which such owner-employees, or two such or more owner-employees, are considered to control.

For years beginning after December 31, 1996, the special aggregation rules are repealed. The only special requirement for owner-employees will be the requirement that the plan must provide that contributions on behalf of any employee may only be made with respect to the earned income of such owner-employee, which is

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derived from the trade or business with respect to which such plan is established.

The Section 415 Limit for Combined Defined-Benefit and Defined-Contribution Plan is Repealed

This change should be titled, "The Rebirth of Defined-Benefit Plans Act" or "The Pension Retirement Act for the Wealthy." The combined plan limit is repealed for limitation years starting after 1999.

More businesses are now going to want a defined-benefit plan, even small one-person businesses. This includes those which have existing plans.

Change in Rules For Prohibited Transactions

Effective on date of enactment, any prohibited transaction occurring on or after enactment is subject to a 10% excise tax rather than a 5% excise tax.

Effective December 22, 1987 (i.e. retroactive), a law change is made to accomplish the intent of a 1988 law change. Certain transactions which are exempt for the PT rules of ERISA were also to be exempt from the PT rules of the Code. It was not meant that this special rule apply to all situations, but only those under ERISA section 408(B)(12). This is now the new law.

Enactment of Waiver of Waiting Period For QJSA

Previously, the IRS had ruled that there could be a waiver of the 30-day waiting period. This has now been enacted into law, effective for plan years commencing after December 31, 1996.

A plan may permit a participant to elect (with any applicable spousal consent) to waive any requirement that the written explanation be provided at least 30 days before the annuity starting date, if the distribution commences more than 7 days after such explanation is provided.

A plan may provide the written explanation after the annuity starting date. If so, the election period cannot end before the 30th day after the date on which such explanation is provided. The Secretary may limit this right to a certain degree by regulation.

Model IRS Forms for QDROs and QPSA/QJSA

By January 1, 1997, the IRS is required to prepare model language covering the topic of spousal consent. A QDRO is a Qualified Domestic Relations Order. Apparently the belief is that there will be more compliance with existing law if the IRS assists attorneys and judges.

Likewise, another troublesome area is the drafting of qualified pre-retirement survivor annuity forms and qualified joint and survivor annuity forms. The concept is that the law mandates a certain form of benefit (which most people don't want), and both the participant and his or her spouse must sign a waiver if they would like a different payment method. If the form is not adequately written, then any purported waiver fails. People want to know that the form (notice and waiver) will not fail. The IRS language must be written in a manner to be understood by the average person and must disclose in plain form whether the waiver is irrevocable and whether it may be revoked by a QDRO.

Expansion of Employers Eligible to Sponsor 401(k) Plans

Tax-exempt organizations may sponsor 401(k) plans for plan years commencing after December 31, 1996.

Indian tribal governments, subdivisions, agencies or corporations will also be able to sponsor 401(k) plans for years commencing after December 31, 1996.

State and local governmental entities or subdivisions are still barred from sponsoring 401(k) plans.

New definition of rural cooperative plan.

Law Changes Simplifying Distributions/Raising Tax Revenues

The death-benefit exclusion is repealed for those decedents dying after the date of enactment. The date of enactment is August 20, 1996.

Five-year averaging is repealed for lump-sum distributions for years beginning after December 31, 1999.

Those people who were grandfathered in for 10-year averaging and capital gains treatment are still eligible for such special rules. Those people who were age 50 before January 1, 1986, were grandfathered.

Suspension of Assessment of 15% Excess-Distribution Tax for 1997-1999

This is an extremely important law change for those people who have "large" IRA and other pension account balances. The policy goal is to raise current tax dollars which otherwise would not be paid now. There is an incentive to not have to pay the 15% excise tax.

The suspension of the 15% excise tax does not apply to the estate situation.

Simplified Method for Taxing Annuity Distributions

This new method applies to distributions from a qualified plan, a qualified annuity, and a tax-sheltered annuity.

This method is effective with annuity starting dates that are later than 90 days after the date of enactment.

Employee contributions under a defined-contribution plan may still be treated as a separate contract for purposes of applying this method.

The new rule: The portion of each annuity payment that represents the return of nontaxable basis (investment in the contract) is determined by dividing the annuitant's basis as of the annuity starting date by a factor (number of anticipated payments) based upon age from the following table:

Age of Annuitant on the Annuity Starting Date	Number of Anticipated Payments
55 and under	**360**
56-60	**310**
61-65	**260**
66-70	**210**
71 and over	**160**

Example: David is age 57. He receives a monthly annuity payment of $400 per month. His contributions to the defined-benefit plan as of the annuity starting date were $30,000. His nontaxable portion is $96.77 ($30,000/310).

This simplified method applies to an annuitant who has attained age 75 only if there are fewer than 5 years of guaranteed payments.

Basis is determined without regard to an adjustment for a refund feature.

If there is a lump-sum payment along with the commencement of the annuity, then the lump-sum payment is taxed under section 72(e) as if received before the annuity starting date and the basis is adjusted accordingly.

Determination of Unrecovered Basis in Annuity Contract

This is a technical correction. It applies to those individuals whose annuity starting date is after December 31, 1986.

Concept: If the annuity payments cease before the annuitant dies, then the person will recover his or her entire investment in an annuity with a refund feature. If an annuitant dies before recovering his or her full basis, the unrecovered amount may be deducted on the person's final tax return. However, if the annuity has a refund feature, then the basis must be reduced under section 72(c)(2) by the pre-

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sent value of the refund feature. In order to ensure full recovery of basis, the definition of unrecovered basis is changed so that the special reduction is not considered for this purpose.

New Required Beginning Date for Some Participants

The new rule applies to all participants except 5% owners and IRAs. Thus, the rules do not change for most one-person Keogh owners. Their required beginning date is still April 1 of the year following the year age 70 1/2 is attained.

The required beginning date for non-5% owners is April 1 of the calendar year following the later of:

(1) the calendar year in which the employee attains age 70 1/2, or

(2) the calendar year in which the employee retires.

When a person retires in any year after his or her 70 1/2 year, the employee's account balance must be actuarially increased in order to reflect the value of benefits that the employee would have received if he or she had commenced benefits at age 70 1/2. Note that the conference report states that this actuarial adjustment rule does not apply to defined-contribution plans (profit sharing, money purchase and 401(k)).

Governmental plans and church plans are not subject to the actuarial adjustment rule, and the 5% owner rule does not apply to such plans.

These new rules apply for years beginning after December 31, 1996.

The conference report indicates that a plan may permit a person currently receiving distributions, but who is still employed, to elect to stop distributions until required to commence them under the new rule. That is, a person, age 75, who is still working, must take his RMD for 1996, but would not be required to take it for 1997.

Law Changes - Simplifying the Nondiscrimination Rules (All Plans)

Modified the Minimum Participant Rule

Current Rule: A plan, to be qualified, must benefit at least the lesser of 50 employees or 40% of all eligible employees. This applies to both defined-contribution and defined-benefit plans.

New Rule: A defined-benefit plan must benefit at least the lesser of: 50 employees, or the greater of: (a) 40% of all employees, or (b) 2 employees (but only one if there is only one employee).

The new rule no longer applies to defined-contribution plans. This will have a big impact and will require plan document changes. This change is effective for plan years beginning after December 31, 1996.

Repeal of the Family Aggregation Rules

This is an extremely beneficial change for those small businesses with multiple-family employees.

This change is effective for tax years beginning after December 31, 1996.

The old rules requiring aggregation meant that family members' elective deferrals were severely restricted.

Family members who are not highly compensated may now be considered in the ADP testing, and their inclusion, in most cases, will allow the highly-compensated employees to make larger deferrals.

Revised Definition of Highly-Compensated Employees

Effective for Years Beginning After December 31, 1996

A highly-compensated employee is one who is either: (1) a 5% owner at any time during the current year or the preceding year, or (2) had compensation from the employer in excess of $80,000, and if the employer so elects, was in the top-paid group (top 20%).

The rule requiring the highest paid officer to be treated as highly-compensated has been repealed.

The employer has the choice of considering all people who earn more than $80,000 as highly-compensated, or only those who are in the top 20% of employees by pay. This means, in some cases, people earning $80,000 or more could be considered nonhighly compensated for testing purposes, and this should improve the ratio for the nonhighly-compensated group.

Also, it appears that an employer will be able to designate employees within a salary range as highly compensated or not. That is, those persons within the group with a high ADP would be put into the nonhighly-compensated range, and those with low percentages would be put into the highly-compensated group.

Revised Definition of Compensation for Section 415 Purposes

Participant's compensation shall include any elective deferral (under a 401(k), SAR-SEP, 403(b) or SIMPLE) and any amount which is contributed or deferred by reason of section 125 or 457.

The special compensation rule for disabled participants of a defined-contribution plan has been modified so that contributions may even be made for highly-compensated disabled participants. The new rule is — continuation of contributions on behalf of all participants ... for a fixed or determinable period.

Use of a Uniform Retirement Age.

It is permissible to use the Social Security Retirement Age without failing the nondiscrimination tests. Social Security age will be 66 for those people born after 1937, but before 1955, and age 67 for those born after 1954. That is, subsidized early retirement benefits and qualified joint and survivor annuities will not be treated as unavailable on the same terms.

New Rule Regarding Leased Employees

In order to be a leased employee, the employer must have an agreement with a leasing organization, such person (the leased employee) must perform services for the employer on a substantially full-time basis for at least one year, and such services are performed under the primary direction or control by the recipient.

Law Changes - Simplifying the Nondiscrimination Rules for 401(k) Plans

Nondiscrimination testing may be done by reference to prior-year data. That is, the maximum ADP and ACP for highly-compensated employees for the current plan year is determined by reference to the ADP and ACP of the nonhighly-compensated employees for the prior plan year.

A special rule applies for the first plan year. The amount taken into account as the ADP for the preceding plan year shall be 3%, or if the employer makes a special election, the ADP of nonhighly-compensated employees determined for such first year. This special rule does not apply to successor plans.

If an employer would wish, it could elect to use the current year's ADP and ACP of the nonhighly compensated. Once this election is made it can only be changed as provided by the Secretary of the Treasury.

This change is effective for years commencing after December 31, 1996.

Under existing law, elective deferrals to be made by the highly-compensated employees was dependent upon the elective deferrals made by the nonhighly-compensated employees. That is, most often a highly-compensated employee could not defer $9,500 because of the ADP limits. This symbiotic relationship no longer is required if the 401(k) plan meets one of two safe harbors.

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Safe Harbor #1 - A plan is deemed to meet the antidiscrimination rules if it meets a notice requirement and one of two contribution requirements. This safe harbor applies to years commencing after December 31, 1998.

The Notice: Each eligible employee must be given, within a reasonable period prior to any year, a written notice of his or her rights under the 401(k) plan. This notice must be sufficiently accurate and comprehensive and must be written in a manner calculated to be understood by the average employee eligible to participate.

The Contribution Requirement

Option #1. The employer is required to make a qualified nonelective employee contribution equal to 3% of compensation for each nonhighly-compensated employee. Or,

Option #2. The employer makes qualified matching contributions on behalf of each nonhighly-compensated employee in an amount equal to: (a) 100% of the elective contributions of the employee, but not to exceed 3%, and (b) 50% of the elective deferrals to the extent that such deferrals exceed 3% but do not exceed 5% of the employee's compensation.

The contribution requirement is not met if the rate of matching contribution for a highly-compensated employee exceeds the matching rate for a nonhighly-compensated employee.

Even though the matching rate does not equal the percentage required above under option #2, the plan can still qualify if: (a) the rate of the employer's match does not increase as an employee's rate of elective contributions increases, and (b) the aggregate amount of matching contributions at such rate of elective contributions is at least equal to the aggregate amount of matching contributions which would be made if matching contributions were made according to option #2.

Note that the employer may not reduce the matching percentage to less than 3% as may be done with a SIMPLE-IRA.

Safe Harbor #2 - A plan is deemed to meet the antidiscrimination rules and the top-heavy rules if it complies with the SIMPLE rules for a 401(k) plan. That is, a special contribution rule must be met, an exclusive plan rule must be met, and there must be 100% vesting.

The Special Contribution Rule: An employee must have the right to elect to have the employer make, on his or her behalf, elective contributions which must be expressed as a percentage of compensation, but which is limited to $6,000. The employer is then required to make one of two types of contributions: (1) a matching contribution equal to 3% of compensation, or (2) make a qualified nonelective contribution of 2% of compensation for each eligible employee who has at least $5,000 of compensation for that year. The employer must notify employees of this election within a reasonable period of time before the 60th day before the beginning of such year.

There can be no other contributions (or benefit accrued) to this plan or any other plan.

It appears that the 401(k) SIMPLE may be available to employers with more than 100 employees. The statute does not contain the 100-employee limitation.

There is a safe harbor for meeting the ACP test for employer matching contributions. There are two requirements:

The Notice Requirement: Each eligible employee must be given, within a reasonable period prior to any year, a written notice of his or her rights under the 401(k) plan. This notice must be sufficiently accurate and comprehensive and must be written in a manner calculated to be understood by the average employee eligible to participate.

The Contribution Requirement:

Option #1. The employer is required to make a qualified nonelective employee contribution equal to 2% of compensation for each nonhighly-compensated employee. Or,

Option #2. The employer makes qualified matching contributions on behalf of each nonhighly-compensated employee in an amount equal to: (1) 100% of the elective contributions of the employee, but not to exceed 3%, and (2) 50% of the elective deferrals to the extent that such deferrals exceed 3% but do not exceed 5% of the employee's compensation.

Satisfies a special limitation on matching contributions. Three conditions must be met: (1) matching contributions may not exceed 6% percent of compensation, (2) the rate of an employer's matching contribution does not increase as the rate of deferrals increase, and (3) the matching contribution for highly-compensated employees at any rate cannot be greater than the rate for nonhighly-compensated employees.

Special Rule for Plans Providing Early Participation

Some 401(k) plans allow employees to participate before they have satisfied the statutory eligibility requirements of one year of service and reaching age 21. A 401(k) plan may elect to disregard those nonhighly-compensated employees who are eligible to participate but who do not have the one year of service, or are not yet age 21. That is, the ADP of the eligible highly-compensated employees is compared to the ADP of the eligible nonhighly-compensated employees, but excluding those who do not have the one year of service or who are not yet age 21. To make this election, the plan must meet the section 410 rules without taking into account those employees who have not met the minimum age and service requirements.

Distributions of Excess Contributions (and Excess Aggregate Contributions)

Under existing law, the method of correction was that the highly-compensated employees with the highest deferral percentage would have their deferrals reduced first until the ADP test was met.

For plan years commencing after December 31, 1996, the method of correction will be that excess contributions will be first taken from those highly-compensated employees who have the greatest dollar amount of deferrals.

Veteran's Reemployment Rights

Technical corrections are made so that a qualified plan cannot be disqualified when it complies with the Uniformed Services Employment and Reemployment Act of 1994 (USERRA).

Qualified Plans must now provide the rights required by USERRA. PD

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IRA Distribution Planning

An IRA accountholder does not generally pay income tax with respect to his or her IRA until there is a distribution. A basic tax planning concept is that it is highly desirable that the marginal tax bracket rate which applies at the time of the IRA contribution is greater than the marginal tax bracket rate which applied at the time of the IRA distribution.

IRA accountholders should be aware that it is very possible that the marginal tax bracket rate at time of distribution could be 0%. That is, the distribution will not be subject to income tax.

Why? The current tax rules provide for a standard deduction and a deduction for exemptions. The taxpayer's adjusted gross income is first reduced by the standard deduction and then by the number of total exemptions. In many situations, the person's taxable income will be zero after these two reductions.

The amount of each exemption is $2,500. The amount of the standard deduction is determined by the charts set forth below.

CHARTS FOR THE STANDARD DEDUCTION

Regular Chart (Filing Status) (Those Not 65 or Older or Blind)

Single	$3,900
Married Filing Jointly (or qualifying widower)	$6,550
Head of Household	$5,750
Married Filing Separately	$3,275

Special Chart For Those 65 or older and/or Blind

Single - 65 and older	$4,850
Single - 65 and older and blind	$5,800
Married Filing Jointly - one 65 and older and neither blind	$7,300
Married Filing Jointly - one 65 and older and one blind	$8,050
Married Filing Jointly - one 65 and older and two blind	$8,800
Married Filing Jointly - two 65 and older and neither blind	$8,050
Married Filing Jointly - two 65 and older and one blind	$8,800
Married Filing Jointly - two 65 and older and two blind	$9,550

Qualifying Widower - Same Five Charts Apply as for Married Filing Jointly

Head of Household - 65 and older	$6,700
Head of Household - 65 and older and blind	$7,650

Married Filing Separately - use same five charts that apply for Married Filing Jointly except reduce each amount by $3,275.

The IRS has designed the chart on the next page to indicated those people who are required to file an income tax return. Conversely, those people with adjusted gross incomes less than these amounts are not required to file a return.

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Although somewhat simplistic (i.e. not exactly true), this chart is essentially created by adding together the exemption amount of $2,500 per person with the proper standard deduction amount.

Chart A — For Most People

To use this chart, first find your marital status at the end of 1995. Then, read across to find your filing status and age at the end of 1995. You must file a return if your **gross income**** was at least the amount shown in the last column.

Marital Status	Filing Status	Age*	Gross Income**
Single (including divorced and legally separated)	Single	under 65 65 or older	$6,400 7,350
	Head of household (see page 12)	under 65 65 or older	$8,250 9,200
Married with a child and living apart from your spouse during the last 6 months of 1995	Head of household (see page 12)	under 65 65 or older	$8,250 9,200
Married and living with your spouse at end of 1995 (or on the date your spouse died)	Married, joint return	under 65 (both spouses)	$11,550
		65 or older (one spouse)	12,300
		65 or older (both spouses)	13,050
	Married, separate return	any age	$2,500
Married, not living with your spouse at the end of 1995 (or on the date your spouse died)	Married, joint or separate return	any age	$2,500
Widowed before 1995 and not remarried in 1995	Single	under 65 65 or older	$6,400 7,350
	Head of household	under 65 65 or older	$8,250 9,200
	Qualifying widow(er) with dependent child (see page 12)	under 65 65 or older	$9,050 9,800

* *If you turned age 65 on January 1, 1996, you are considered to be age 65 at the end of 1995.*

** ***Gross income** means all income you received in the form of money, goods, property, and services that is not exempt from tax, including any gain on the sale of your home (even if you may exclude or postpone part or all of the gain). **Do not** include social security benefits unless you are married, filing a separate return, and you lived with your spouse at any time during 1995.*

Example #1: Betty Montgomery is married. She and her husband are both age 66 and neither is blind. They have taxable interest and dividend income of $6,000 in addition to their social security. Betty has $5,000 in her IRA. They want to understand what federal income tax they will have to pay if she withdraws these funds in 1996. For discussion purposes, we will assume that the amounts which applied for 1995 also apply for 1996. Betty and her husband file a joint income tax return.

Their adjusted gross income would be $11,000. Because this is less than $13,050 ($5,000 exemption plus the standard deduction of $8,050), they will not owe any federal income tax on the $5,000 distribution. The IRA custodian will report to the IRS that she was paid $5,000 on the Form 1099-R. Even so, Betty is not required to file a federal income tax return because their adjusted gross income (including the IRA distribution) is less than the amount which would require them to file a tax return.

Example #2: Dan Mulroy is married. He is 67 and his wife is age 61. Neither is blind. They have taxable interest and dividend income of $8,000 in addition to their social security. They have not other taxable income. In 1996, Dan withdraws $4,000 from his IRA which has a balance of $50,000. They file a joint income tax return.

Their adjusted gross income would be $12,000. Because this is less than $12,300 ($5,000 exemption plus the standard deduction of $7,300), he will not owe any federal income tax on the distribution of the $5,000. The IRA custodian will report to the IRS that he was paid $5,000 on the Form 1099-R. They are not required to file a federal income tax return because his adjusted gross income (including the IRA distribution) is less than the amount which would require them to file a tax return.

Example #3: Jan Woolery is single. She is 72 and is not blind. She has taxable interest and dividend income of $7,000 in addition to her social security. She has no other taxable income. In 1996, Jan withdraws $5,000 from her IRA which has a balance of $70,000.

Her adjusted gross income would be $12,000. Because this is more than $7,350, she must file an income tax return and pay a tax equal to 15% of $4,650, or $697.50.

The intent of the above illustrations is to show that some IRA accountholders will not pay any income tax when they take a distribution from their IRA. This surprises some older people because they remember that they received a tax deduction when they made their IRA contribution, and now they believe that surely they are going to have to pay the IRS. Some of these people may actually not be taking distributions because they don't want to pay any taxes. These people may not realize that no taxes might be owing. This happens if their other taxable income is sufficiently low. You may well have some IRA accountholders who could structure their IRA withdrawals over a number of years so no income tax would be owing or would be minimized.

There are other special situations when an individual is required to file an income tax return even though he or she has income below the above limits. For example, an individual who owes any excise tax related to an IRA or pension (10% pre-59 1/2 tax, or 50% excess accumulations tax) or the alternative minimum tax, must still file a return. PD