The Pension Digest

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Necessity for Furnishing IRA Amendments

There is some confusion regarding whether or not an IRA custodian or trustee must (versus should) furnish an IRA amendment because of the law changes brought by the Small Business Job Protection Act or the Health Insurance Portability and Accountability Act.

The purpose of this article is to discuss the necessity or desirability of furnishing an IRA amendment after there has been a statutory or regulatory law change. An IRA custodian or trustee furnishes two documents to the IRA accountholder when the IRA is established — an IRA plan agreement and an IRA disclosure statement. In some cases there needs to be an amendment to the IRA plan agreement and in other cases there needs to be an amendment to the IRA disclosure statement.

Internal Revenue Code regulation 1.408-6 contains very specific rules for the situation when the IRA plan agreement is amended. If the change to the IRA plan agreement affects a topic required to be discussed in the disclosure statement, then there must be a disclosure statement amendment furnished which sets forth the new rules. The IRA custodian must furnish the amendment no later than the 30th day after the later of the date on which the IRA plan agreement amendment is adopted or becomes effective. The amendment must be furnished by delivery or mail to the last known address of the IRA accountholder or inheriting beneficiary.

The regulation governing the preparation of disclosure statements does NOT address the situation where the IRA law or rules are amended, but the IRA plan agreement is not changed or revised. Does there need to be an amended disclosure statement?

Prior to The Tax Reform Act of 1986 (TRA 86), the IRA plan agreement did not address the topics of claiming a tax deduction for one's IRA contribution because that was inherent when one made his or her IRA contribution. Why? Every IRA distribution had to be included in gross income for taxation purposes. TRA 86 brought the new rules regarding nondeductible IRA contributions and nontaxable IRA distributions. The IRA plan agreement (IRS Model Form 5305-A) does not contain any provisions dealing with whether or not a contribution is deductible. The IRS expressly decided to NOT discuss a tax topic (deductible or nondeductible contributions) within the plan agreement.

In 1986 the IRS issued Announcement 86-121. The IRS stated that this announcement could be used by a master or prototype user to update its disclosure statement, required by Treasury Regulations at section 1.408-6. Note that the IRS described the action as an "update" and not as an "amendment." The IRS did not expressly discuss the subject of whether there was a requirement to furnish an IRA disclosure statement amendment when the plan agreement had not been amended.

Most pension consultants concluded that the existing IRA accountholders should be furnished the new rules because the changes made by The Tax Reform Act of 1986 to the laws governing the deductibility of contributions to IRAs were major. Many people were no longer eligible to claim a deduction for the amount of their IRA contribution, and they should be informed of the new rules.

Most IRA consultants have concluded that the most prudent course of action for an IRA custodian is to furnish an updated (i.e. an amendment) disclosure statement whenever there is a change in a tax law or banking regulation affecting the IRA rules. This is recommended even if the change does not require an amendment to the IRA plan agreement.

CWF has not and will not say that the furnishing of an amendment is mandatory when the law has changed, but the IRS has not revised the IRA plan agreement. On the other hand, we will never recommend to an IRA custodian that they need not furnish an amendment. We could not guarantee that the IRS would not seek to impose the fine of $50 per IRA accountholder which the IRS can assess with respect to an IRA custodian's failure to comply with the disclosure statement rules. We can also not guarantee that there is not a fiduciary duty to furnish an amendment independently of the IRS.

Previously, we informed IRA custodians that they could wait to see when and if the IRS would be amending the IRA plan agreement. It was reasonable to do this because it was not clear as to

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Also in this issue –

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IRS Issues 1996 Version of Publication 560 — Retirement Plans for the Self-Employed

The IRS has issued the 1996 version of Publication 560. With the law changes, there are numerous revisions. You may wish to have copies available for your small business customers. CWF has copies available for $1.00 per copy. You may call 1-800-346-3961 to order.

We have decided to reprint, or include within *The Pension Digest*, the summary of changes found on page 2 of IRS Publication 560 and those portions of pages 8 and 9 which summarize the new SIMPLE retirement plan. The IRS has done a very good job and you will find this information helpful.

Summary of New Law Changes

Important Changes for 1996

The following new tax law provisions on retirement plans may affect you in 1996.

Excise tax increase—Prohibited transactions. Any prohibited transaction that takes place ***after August 20, 1996*** is subject to an excise tax of 10% on the "amount involved." For more information, see *Prohibited Transactions.*

Other changes. Publication 553. *Highlights of 1996 Tax Changes,* contains information on other changes to pension provisions (not covered in this publication) that may affect your ***1996 income tax return.***

Important Changes for 1997

The following new tax law provisions on retirement plans may affect you in 1997.

Savings Incentive Match Plan for Employees (SIMPLE). Beginning in ***1997,*** you may be able to set up a SIMPLE retirement plan. The SIMPLE plan allows an employer to contribute to a SIMPLE retirement account on behalf of each employee. The SIMPLE plan:

1) Can be used only by an employer with 100 or fewer employees, who received at least $5,000 of compensation from the employer for the preceding year.
2) Can be established as an IRA or as part of a 401(k) plan.
3) Allows each employee to elect to contribute a percentage of his or her compensation to the SIMPLE plan under a salary reduction arrangement. This amount may not exceed $6,000 for 1997.
4) Requires the employer to match employee's contributions on a dollar-for-dollar basis, up to 3% of compensation, OR the employer may elect to make a 2% nonelective contribution on behalf of all eligible employees, and
5) Must be the only retirement plan of the employer.

See *SIMPLE Retirement Plans* after the *Simplified Employee Pension (SEP)* discussion.

Repeal of salary reduction arrangement under a SEP (SARSEP). After December 31, 1996, an employer is no longer allowed to establish a Salary Reduction Simplified Employee Pension (SARSEP) plan. However, participants (including new participants) in a SARSEP that was established before 1997 can continue to elect to have their employer contribute part of their pay to the plan. See *Salary Reduction Arrangement* under *Simplified Employee Pension (SEP).*

Minimum required distribution rule modified. Beginning in ***1997,*** new law modifies the definition of the required beginning date that is used to figure the minimum required distribution from qualified retirement plans. Under the new law, the required beginning date of a participate who is still employed after 70 1/2 is April 1 of the calendar year that follows the calendar year in which he or she retires. For years prior to 1997, participants in qualified plans and IRAs must begin distributions by April 1 of the year following the calendar year in which he or she reaches age 70 1/2, whether or not the participant has retired. The new law change does not apply to IRAs. For more information on the minimum distribution rules, see *Required Distributions* under *Distributions* in the *Keogh Plans* discussion.

15% tax on excessive distributions suspended. The new law suspends the 15% excise tax on excessive distributions for distributions received ***after December 31, 1996*** and before the year 2000. For 1996, the distributions in excess of $155,000 are subject to a 15% excise tax on the amount over $155,000. For more information, see *Tax on Excess Distributions in* Publication 575, *Pension and Annuity Income,* or Publication 553.

New definition of highly-compensated employee (HCE). For years beginning ***after 1996,*** a **highly-compensated employee** is an employee who:

1) Was a 5% owner of the employer at any time during the year or the preceding year, or
2) Received more than $80,000 in compensation (indexed for inflation) from the employer during the preceding year and was in the top-paid group of employees for that year.

For more information regarding the definition that applies to 1996, see *Definitions* under *Simplified Employee Pension (SEP).*

Family aggregation rules repealed. For years beginning ***after 1996,*** the special aggregation rules that only apply to self-employed individuals are eliminated. See *Additional Rules for Plans Covering Owner–Employees,* near the end of the publication.

Definition of "leased employee" modified. For years beginning ***after 1996,*** the definition of "leased employee" has changed. See *Keogh Plan Qualification Rules,* for more information.

New law on waiver or survivor benefit. For plan years beginning ***after December 31, 1996,*** a plan participant may elect to waive (with spousal consent) the 30-day election period if the retirement distribution begins more than 7 days after a written explanation of the qualified joint and survivor annuity is provided.

For more information, see *Survivor benefits,* near the end of the publication.

Important Reminder

Plan amendments required by changes in the law. If your Keogh plan needs to be revised to conform to recent legislation, you may choose to get a determination letter from your IRS key district office approving the revision. Generally, mater and prototype plans (but not the elections in their related adoption agreements) are amended by sponsoring organizations. However, there are instances when you may need to request a determination letter regarding a master or prototype plan that is a nonstandardized plan and that you maintain. Your request should be made on the appropriate form (generally Form 5300 or 5307 for a master or prototype plan) and should be filed with Form 8717 and the appropriate user fee (see Publication 1380, *User Fees).*

You may have to amend your plan to comply with recent tax law changes made by the small Business Job Protection Act of 1996. Public Law 104-188. You do not need to make these amendments before the first day of the first plan year beginning in 1998.

You may also have to amend your plan to comply with law changes made by the Uruguay Round Agreement, Public Law 103-465. Generally, you need not make any amendment until a later date to be provided by IRS.

For further information, contact employee plans taxpayer assistance telephone service between the hours of 1:30 p.m. and 4 p.m. Eastern Time, Monday through Thursday, at (202) 622-6074/6075. (These are not toll-free numbers.)

Introduction

This publication discusses retirement plans that can be used by self-employed persons and partnerships. These plans are called Simplified Employee Pension (SEP) plans and H.R. 10 (Keogh) plans. ***For purposes of these plans, a self-employed individual is both an employer and employee.*** Under a SEP plan, contributions are made to individual retirement arrangements (SEP-IRAs) set up for all employees who qualify. A SEP can also be set up by a corporation.

Beginning in 1997, a new ***SIMPLE retirement plan*** will be available to small employers (including self-employed individuals). See *SIMPLE Retirement Plans* after the *Simplified Employee Pension (SEP)* discussion.

SIMPLE Retirement Plans

A SIMPLE plan is a written salary reduction arrangement that allows a small business (an employer with 100 or fewer employees) to make elective contributions to a SIMPLE retirement account on behalf of each eligible employee. An ***eligible employer*** is not allowed to maintain another retirement plan.

Setting up a SIMPLE Plan

If am employer has 100 or fewer employees (who received at least $5,000 of compensation from the employer for the preceding year), the employer may be able to set up a SIMPLE retirement plan on behalf of eligible employees. The plan can be either:

- an IRA for each eligible employee or
- part of a qualified cash or deferred arrangement (a 401(k) plan).

The SIMPLE plan must be the only retirement plan of the employer to which contributions are made, or benefits are accrued, for service in any year beginning with the year the SIMPLE plan becomes effective.

Under the ***qualified salary reduction arrangement*** the employer's contributions on behalf of the employee (elective deferrals) are stated as a percentage of the employee a ***compensation*** and are limited to $6,000. The dollar limit is indexed for inflation in $500 increments.

TIP *The terms emphasized here are defined later in detail.*

Under the ***qualified salary reduction arrangement*** the employer is also required to make either a matching contribution to the SIMPLE retirement account on behalf of each employee who elects to make elective deferrals, or a nonelective contribution to the SIMPLE retirement account on behalf of each eligible employee. These two methods for determining the employer contribution formula are explained under *Dollar-for-dollar employer matching contributions* and 2% *nonelective contributions.*

Contributions to a SIMPLE Plan are deductible by the employer and are excluded from the gross income of the employee.

Definitions

Simple retirement account. The SIMPLE retirement account of an ***eligible employee*** is an individual retirement plan that can be either an individual retirement account or an individual retirement annuity, as described in Publication 590, *Individual Retirement Arrangements (IRAs).* Employees' rights to the contributions cannot be forfeited.

A SIMPLE plan can also be set up as a 401(k). See *SIMPLE 401(k)*, later.

Qualified salary reduction arrangement. An employee eligible to participate in the SIMPLE plan may elect (during the 60-day period before the beginning of any year) to have the employer make contributions (called elective deferrals) the SIMPLE retirement account on his or her behalf. An employee who so elects may also stop making elective deferrals at any time during the year. The employer is required to match the employee's contributions or to make nonelective contributions. No other types of contributions are allowed under the qualified salary reduction arrangement.

Eligible employer. Any employer who has 100 or fewer ***eligible employees*** in any year can establish a SIMPLE plan provided the employer does not maintain another employer-sponsored retirement plan.

Eligible employee. Any employee who receives at least $5,000 in compensation during any 2 years preceding the plan year can elect to have his or her employer make contributions to a SIMPLE retirement account under a qualified salary reduction arrangement. The employee must be expected to earn at least $5,000 during the calendar year.

Excludable employee. Excludable employees include certain nonresident aliens and employees whose retirement benefits are covered by a union agreement. See *Definitions* under *Simplified Employee Pension (SEP)*, earlier.

Compensation. Compensation for employees is the total amount amount of wages required to be reported on Form W-2, plus elective deferrals. For the self-employed individual, compensation is the net earnings from self-employment (without regard to any contribution made to the SIMPLE plan for the self-employed individual.)

TIP *Any SIMPLE elective deferrals related to an employee's wages under a salary reduction arrangement are included in the Form W-2 wages for social security and Medicare tax purposes only.*

Contribution Limits

Contributions are made up of employee elective deferrals and employer contributions. The employer is required to satisfy one of two contribution formulas; the matching contribution formula or a two-percent nonelective contribution. No other contributions can be made to the SIMPLE plan. These contributions, which are deductible by the employer, must be made timely.

Employee elective deferral limit. The amount that the employee elects to have the employer contribute to a SIMPLE retirement account on his or her behalf (elective deferrals) must not exceed $6,000 for any year and must be expressed as a percentage of the employee's compensation.

Dollar-for-dollar employer matching contributions. The employer is required to match all eligible employees' elective contributions, on a dollar-for-dollar basis, up to 3% of the employee's compensation.

CAUTION *If the employer elects a matching contribution that is less than 3%, the percentage must not be less than 1%. The employer must notify the employees of the lower match within a reasonable time before the employee's 60-day election period for the calendar year. A percentage less than 3% cannot be elected for more than two years during a five-year period.*

2% nonelective contributions. In lieu of the dollar-for-dollar matching contributions, the employer may elect to make nonelective contributions of 2-percent of compensation on behalf of each eligible employee. Only $150,000 of the employee's compensation can be taken into account to figure the contribution limit.

CAUTION *If the employer elects this 2% contribution formula, he or she must notify the employees timely (within the employee's 60-day election period described earlier).*

Time limits for contribution funds. The employer is required to contribute the employee's deferral to the SIMPLE account within 30 days after the end of the month for which the payments to the employee were deferred. The employer's matching contributions to the SIMPLE plan, however, are required to be made by the tax return filing deadline, including extensions, for the taxable year that begins with or within the calendar year for which the contributions are made.

Distributions (Withdrawals)

Distributions from a SIMPLE retirement account are subject to IRA rules and are includible in income when withdrawn. Tax-free rollovers can be made from one SIMPLE account into another SIMPLE account or into an IRA. Early withdrawals generally are subject to a 10% (or 25%) penalty.

See Publication 590 for information about IRA rules, including those on the tax treatment of distributions, and income tax withholding.

Exceptions. A rollover to an IRA can be made tax free only after a 2-year participation in the SIMPLE plan. A 25% penalty for early withdrawal applies if funds are withdrawn within 2 years of beginning participation.

Reporting and Disclosure Requirements

The *trustee* of a SIMPLE account is required to:

- Annually provide the employer with a summary description containing basic information about the plan.
- Furnish each SIMPLE plan participant an account statement for the calendar year within 330 days after each calendar year.
- Furnish an annual report to the IRS.

Employee notifications. The *employer* who sets up a SIMPLE plan must notify each eligible employee of his or her opportunity to make contributions under the plan. The employer must also notify all eligible employees of the contribution alternative that was chosen. This information must be provided before the beginning of the employee's 60-day election period.

SIMPLE 401(k) plan

A SIMPLE plan can also be adopted as part of a 401(k) plan. The SIMPLE 401(k) plan must satisfy all the rules that usually apply to 401(k) plans, except for the following qualification rules for which a safe harbor is provided. See *Keogh Plan Qualification Rules* later.

Safe harbor provisions. A SIMPLE 401(k) plan that satisfies the contribution requirements and the vesting rules of a SIMPLE-IRA does not have to meet the ***nondiscrimination rules*** that apply to employee elective deferrals and employer matching contributions.

The SIMPLE-IRA contribution rules that must be met are:

1) $6,000 limit on employee deferrals,
2) Dollar-for-dollar employer matching contributions, up to 3% of compensation; or,
3) Alternative 2% of compensation nonelective contribution, and
4) No other contributions are made to the SIMPLE 401(k) plan.

Note. The employer cannot reduce the matching percentage below 3% of compensation for the SIMPLE 401(k) plan.

However, the safe harbor is not satisfied for any year in which (for service for that year) the employer makes contributions to, or benefits are accrued under, any retirement plan of the employer on behalf of employees eligible to participate in the SIMPLE 401(k) plan (other than SIMPLE 401(k) plan contributions discussed above).

In addition, the SIMPLE 401(k) plan is not subject to the ***top-heavy rules*** of qualified plans if the safe harbor is satisfied. PD

✓ Check It Out ✓

Question: Does an IRA custodian need to furnish an IRA amendment along with the January fair market value statement to those accountholders who closed their IRAs in 1996?

✔ Answer. No. You certainly don't need to furnish an IRA amendment, which is effective January 1, 1997, to those former accountholdres who closed their IRAs in 1996. In fact, there is also no need to furnish these individuals the statements. Many IRA custodians choose to furnish statements because they show the posting of interest and other transactions, but there is no IRS requirement to furnish the statement to anyone with a zero balance as of 12-31-96.

Question: May a farmer or other self-employed person establish a SIMPLE-IRA plan? What should a person do?

✔ Answer. Yes, a self-employed person is eligible to sponsor a SIMPLE-IRA plan. This may be very desirable in some situations since there is no 15% or 25% limits as there are with a SEP, profit sharing or money purchase plan. The individual may defer the full $6,000 plus the 3% match. A self-employed person should complete the Form 5305-SIMPLE, Form 5305-SA and the elective deferral instruction form as soon as possible. The elective deferral should be completed so the person has the right to change the deferral percentage. In November or December of 1997, the person will need to "finally" set his or her deferral percentage.

In the same way that self-employed individuals have a great deal of flexibility under a 401(k) plan, these self-employed individuals will have the same flexibility under the SIMPLE-IRA plan.

Question: May an IRA accountholder, who is age 73 but who is still employed, discontinue taking her required minimum distributions from the IRA because of the recent law change? This person thought she had read an article in the AARP magazine that said she could.

✔ Answer. No. The law was changed for qualified plans and tax-sheltered annuities, but it was not changed for IRAs. All IRA accountholders must take a required minimum distribution for the year they attain age 70 1/2 and each subsequent year. The AARP article was not as specific as it should have been. PD

Amendments—*Continued from page 1*

whether the IRS would change the IRA plan agreement, or create a separate SIMPLE-IRA document to handle SIMPLE contributions. The IRS chose the separate plan document approach.

Since it is now clear that the IRS will not be amending the IRA plan agreement (Form 5305-A or 5305), an IRA custodian should be taking steps to furnish a disclosure statement amendment to explain the rules which have changed.

Must the amendment be furnished by January 31, 1997? The regulation does not mandate a deadline of January 31, 1997, for this situation. We recommend that you furnish an amendment on or before January 31, 1997, or as soon as possible thereafter. PD

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IRS Issues Additional Guidance on Required Minimum Distributions From Qualified Plans

The Small Business Job Protection Act of 1996 (SBJPA) changed the deadline for commencing required minimum distributions (RMDs) from a qualified plan and a section 403(b) annuity or account. The IRS has issued Notice 96-47 to provide additional guidance on various required minimum distribution situations. A number of taxpayers had asked, "Must a required minimum distribution be made by April 1, 1997, for a participant (other than a 5% owner) who attains age 70 1/2 in 1996, but has not retired by December 31, 1996?" The IRS answers this question and others within Notice 96-47.

Prior to the SBJPA, the deadline for RMDs was April 1 of the calendar year following the calendar year in which a participant attained age 70 1/2. This meant that those participants who had not retired were required to take in-service distributions. SBJPA changed the deadline for all non-5% owners to be April 1 of the calendar year following the later of the calendar year in which the participant attains age 70 1/2 or the calendar year in which the participant retires. The deadline for a participant who is a 5% owner (i.e. most farmers, ranchers, small business owners, etc.) did not change. The deadline for a 5% owner is still April 1 of the calendar year in which a participant attains age 70 1/2.

The rules for RMDs from IRAs also did not change. It does not matter if the IRA is a regular IRA, a SEP-IRA or a SIMPLE-IRA. The deadline for any type of IRA accountholder is still April 1 of the calendar year following the calendar year he or she attains age 70 1/2.

The IRS stated that the new rules are to be used "in determining the amount of any minimum distribution required to be made during any calendar year beginning on or after January 1, 1997 (that was not required to be made during an earlier calendar year)." We interpret this to mean that any participant (other than a 5% owner) who has not retired before January 1, 1997, will not be required to make a distribution in 1997. The IRS does not expressly state this result, but we believe it is inferred. Why? The SBJPA changed the definition of the required beginning date for all participants (other than 5% owners), not just those participants who attain age 70 1/2 on or after January 1, 1997.

The IRS ruled that a participant (other than a 5% owner) who attains age 70 1/2 in 1996, but who has not retired is not required to take an RMD for 1996. The reasoning: this person's required beginning date is to be determined using the new rule and not the old rule. Thus, this person's required beginning date (i.e. deadline) is not April 1, 1997, but will be the April 1 of the calendar year after the year he or she retires. The IRS also ruled, however, that any distribution in 1996 to a person who attains age 70 1/2 in 1996 is treated as a required minimum distribution for 1996 until the RMD for 1996 has been satisfied. The reasoning: a person who attains age 70 1/2 in 1996 under the pre-SBJPA rules was allowed to wait until April 1, 1997, but was not required to wait. Any distributions in 1996 must first be used to satisfy the RMD requirement. Remember that any RMD is not eligible to be rolled over.

The IRS also stated that the same analysis as discussed above would apply to a participant of a section 403(b) account.

The IRS also addressed the application of the anti-cutback rule. Internal Revenue Code section 411(d)(6)(B) precludes any plan amendment that eliminates an optional form of benefit as it applies to benefits accrued as of the later of the adoption date or the effective date of the amendment. An in-service withdrawal is an optional form of benefit. The IRS has temporarily concluded that an employer could not amend its plan to take away from those participants who attained age 70 1/2 prior to January 1, 1997, the right to have an in-service distribution with respect to such accrued benefits. Therefore, these participants must be allowed to continue their distributions if they wish to do so. An employer which writes its plan to retain in-service distributions after age 70 1/2 (either as a mandatory or an optional form of distribution) will comply with both section 401(a)(9), as amended and with section 411(d)(6)(B). An employer could require such distributions even though the law would not require it to write its plan to require such distributions.

The IRS does have the authority to adopt a regulation which would change the above result so that there could be a plan amendment which would eliminate the right to have in-service withdrawals. The IRS is presently reviewing this question. The IRS has asked for comments. The IRS will weigh the importance to plan participants to continue to receive in-service distributions against the perceived complexity of applying different rules to different participants. Comments should be submitted to the IRS by January 31, 1997.

Conclusion. New RMD rules apply to qualified plans as of January 1, 1997. A participant of a qualified plan (or section 403(b) account) who is not a 5% owner will not need to commence his or her RMD until April 1 of the calendar year following the later of the year the participant attains age 70 1/2 or the year he or she retires. These new rules do not apply to IRAs. PD