THE Pension Digest

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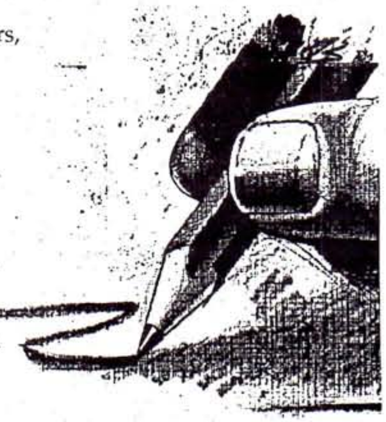
President Clinton Signs the Tax Bill

The Taxpayer Relief Act of 1997 (HR 2014) is now law. It was passed by Congress on July 31, 1997, and signed into law by President Clinton on August 5, 1997. IRAs will be reborn because of these law changes. Individuals who have never made IRA contributions, or who have not made deposits for years, will again make deposits. Congress has created substantial incentives for individuals to save and invest. More specifically, this law changes many of the rules for the "regular" IRA and creates two new types of IRAs — the Roth IRA and the Education IRA.



There will now be three types of IRAs — the regular IRA, the Roth IRA and the Education IRA. It appears that each type of IRA will need to have its own plan agreement and its own software to perform governmental reporting tasks.

This newsletter will be devoted solely to explaining the changes to the regular IRA. The August newsletter will be solely devoted to explaining the Roth IRA. The September newsletter will be primarily devoted to explaining the new Education IRA. The law and rules for the regular IRA are found in Code sections 219 and 408, as are the rules for SEPs, SAR-SEPs and SIMPLEs. The rules for the Roth IRA are found in the new Code section 408A. The rules for the Education IRA are found in Code section 530. PD

Changes to the Regular IRA

The changes to the regular IRA did not turn out to be as monumental as originally proposed, but the changes are still quite favorable. Except when indicated otherwise, these changes go into effect as of January 1, 1998, for the tax year 1998 and not for the tax year 1997.

There are two changes dealing with restoring the ability of some people to claim a tax deduction for their IRA contributions.

Change #1

A married person who was not an active participant in a pension plan, but whose spouse was an active participant, was nevertheless treated as an active participant and the standard phaseout rules ($40,000-$50,000) applied. In many cases, this meant that the spouse who was not covered by a pension plan was still prohibited from claiming a tax deduction for his or her IRA contribution.

This rule has been relaxed but not eliminated. The new rule is — a married person who is not an active participant himself or herself, but whose spouse is, will nevertheless be eligible to claim a full deduction for his or her IRA contribution as long as their joint adjusted gross income does not exceed $150,000. If their adjusted gross income exceeds $150,000, then there will be a phase-out of the amount which can be deducted between $150,000 and $160,000. The rules have not changed if both are active participants in a pension plan.

To gain this new favorable treatment, the person must not be an active participant at any time during any plan year ending with or within the taxable year.

Illustration

Glen and Monica are married. The chart at the bottom of the page sets forth status as an active participant, compensation levels, and

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the amount of any IRA contribution which they would be entitled to claim as a tax deduction. They will be filing a joint income tax return. Two years are illustrated; 1997 and 1998 to show the effect of the law change. The permissible contribution for each is $2,000 because of the spousal contribution rules. Therefore, their combined contribution is $4,000. They are eligible to make nondeductible contributions to the extent their contributions are nondeductible. What portion of their contributions will be deductible? In order to simplify the illustration, it is assumed that they have no income items which would be included in adjusted gross income other than their compensation.

Change #2

There will be a gradual increase in the income limitations which restrict the deductibility of IRA contributions when an IRA accountholder is an active participant in a pension plan. The income limitation rules which apply in 1997 have not been changed since they went into effect on January 1, 1987. During the last 11 years the amount of regular or $2,000 contributions have decreased dramatically. There will be a gradual increase in the amount of IRA contributions. Financial institutions will need to inform or educate the general public. A person is free to contribute to both his or her 401(k) and his or her IRA. The contribution to one does not impact the contribution to the other as long as the person can afford to make both. People who have been making a contribution to a 401(k) plan may now prefer to put it into the IRA as access is easier.

Under 1997 law, a single person's entitlement to a tax deduction is phased out or lost over a scale of $10,000 when his or her adjusted gross income exceeds $25,000. Thus, a single person who is an active participant is not entitled to deduct any portion of his or her $2,000 IRA contribution when his or her adjusted gross income exceeds $35,000.

Under 1997 law, a married couple's entitlement to a tax deduction is phased out or lost over a scale of $10,000 when his or her adjusted gross income exceeds $40,000. Thus, a married person, who is an active participant, is not entitled to deduct any portion of his or her $2,000 IRA contribution when his or her adjusted gross income exceeds $50,000.

Starting with the 1998 tax year, these income limits for both a single person and a married person will increase. There will be an immediate increase of $5,000 for the single person and $10,000 for a married person. And then there will be additional increases according to the schedules set forth at the bottom of page 3.

There Are Two Changes Which Create Additional Exceptions so that the 10% Excess Tax Will Not Be Assessed Even Though the IRA Accountholder Has Not Attained Age 59 1/2

These have been long-discussed exceptions. They have finally become law. Distributions that are used for the purchase of first home or qualified education expenses will not be subject to the 10% penalty tax. It is very important to understand that these exceptions do not apply until after December 31, 1997. Many of your existing IRA accountholders are going to be very interested in these new law changes.

Change #3

A first-time home purchase will not be subject to the 10% excise tax.

What are qualified first-time home buyer distributions? Qualified first-time home buyer distributions are distributions from an IRA which are used to pay the qualified acquisition costs of the principal residence of the first-time home buyer.

Who is a first-time home buyer? The first-time home buyer can be the individual accountholder, the spouse of the accountholder, any child or grandchild of the accountholder, and any ancestor of the accountholder or the accountholder's spouse. To qualify as a first-time home buyer, the individual, and if married, the individual's spouse, must not have had any ownership interest in a principal residence for the two-year period ending on the date of acquisition of the principal residence being purchased under this exception. The date of acquisition is defined as the date a binding contract to purchase the residence is entered into, or the date on which construction or reconstruction of the residence begins.

For which costs can the distribution be used? Qualified acquisition costs include the cost of acquiring, constructing, or reconstructing a residence. The term also includes any usual and reasonable settlement, financing and closing costs. The funds that are distributed for the first-time home purchase must be used within 120 days of the date of the

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Chart — Active Participant Status

Glenn's Compensation	Active Participant (Y) (N)	Monica's Compensation	Active Participant (Y) (N)	Combined AGI	Amount Deductible with Respect to1997 for Monica	Amount Deductible with Respect to1998 for Monica	Amount Deductible with Respect to1997 for Glenn	Amount Deductible with Respect to1998 for Glenn	Combined Deduction with Respect to 1997	Combined Deduction with Respect to 1998	The Difference from 1997 to 1998
$45,000	N	$55,000	N	$100,000	$2,000	$2,000	$2,000	$2,000	$4,000	$4,000	$ -0-
-0-	N	250,000	N	250,000	2,000	2,000	2,000	2,000	4,000	4,000	-0-
30,000	N	. 30,000	Y	60,000	-0-	-0-	-0-	2,000	-0-	2,000	+2,000
100,000	N	30,000	Y	130,000	-0-	-0-	-0-	2,000	-0-	2,000	+2,000
-0-	N	148,000	Y	148,000	-0-	-0-	-0-	2,000	-0-	2,000	+2,000
40,000	N	110,000	Y	150,000	-0-	-0-	-0-	2,000	-0-	2,000	+2,000
40,000	N	115,000	Y	155,000	-0-	-0-	-0-	1,000	-0-	1,000	+1,000
130,000	Y	28,000	N	158,000	-0-	400	-0-	-0-	-0-	400	+400
130,000	Y	30,000	N	160,000	-0-	-0-	-0-	-0-	-0-	-0-	-0-
130,000	Y	130,000	N	260,000	-0-	-0-	-0-	-0-	-0-	-0-	-0-
30,000	Y	25,000	Y	55,000	-0-	1,000	-0-	1,000	-0-	2,000	+2,000
25,000	Y	25,000	Y	50,000	-0-	2,000	-0-	2,000	-0-	4,000	+4,000

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distribution from the IRA to pay the qualified acquisition costs.

What happens if the acquisition or construction is delayed or cancelled after the distribution? If the distributed amount is recontributed, i.e. rolled over, within the 120-day period, there will be no income tax or penalty tax consequences. This results in a change to the rollover rules. This change means that in these situations, the time period for completing a rollover is 120 days and not the normal 60 days. Careful documentation will be necessary to insure compliance with these rules. We do not yet know what type of documentation the IRS may require with a rollover under these rules. If the funds are not recontributed within this time period, the amount will be taxable and subject to the 10% premature distribution penalty.

What dollar limitations are there with this exception? Under this exception, an individual is limited to an aggregate amount of $10,000 for the individual's lifetime. While a person may be able to use this exception more than once in their lifetime, the total lifetime distribution that can fall under this exception is $10,000.

Change #4

IRA distributions used to pay education expenses will not be subject to the 10% excise tax.

Distributions made from an IRA will not be subject to the 10% premature distribution penalty tax in 1998 when they are used to pay qualified education expenses of the accountholder, the accountholder's spouse, children or grandchildren.

What are qualified education expenses? Qualified education expenses include tuition, fees, books, supplies, and equipment required for enrollment or attendance at an eligible educational institution. This amount may also include, for students who are carrying at least one-half of the normal full-time course load, reasonable expense amounts incurred for room and board.

What are eligible educational institutions? An eligible education institution is generally any accredited college, university, junior college, community college or post-secondary vocational institution.

Adjustments to amounts eligible for exception. The amount of educational expenses for which a distribution from an IRA can be used and not be subject to the penalty under this exception must be reduced by the amount of any qualified scholarship, educational assistance allowance, or payment that is excludable from gross income.

There Are Three Changes with Respect to the Contributions Rules — Regular, Spousal and Rollovers

Change #5

There is a combined limit for contributions to the regular IRA and the Roth IRA. The limit is the lesser of 100% of compensation or $2,000.

This rule change does not have that great of a practical effect on the regular IRA as the law adopts the approach that the maximum amount which may be contributed to the regular IRA is not affected by the amount contributed to the Roth IRA because the maximum amount which may be contributed to the Roth IRA is determined as follows: Maximum amount permitted to be made to a regular IRA (i.e. the lesser of 100% of compensation or $2,000) reduced by the amount actually contributed. Thus, if a person contributes $1,500 to his or her regular IRA and $1,500 to his or her Roth IRA, then it is the Roth IRA which will have an excess contribution of $1,000 ($2,000-$1,500-$1,500).

Change #6

Special definitional change for contribution limits under the spousal rules.

Remember that the Small Business Jobs Protection Act of 1996 (SBJPA) changed the rules for spousal IRA contributions as of January 1, 1997, for tax year 1997. No longer is the approach that the compensated spouse makes the contribution on behalf of the noncompensated spouse. The approach now is — the noncompensated spouse will make a contribution for himself or herself after taking into account the contributions which the compensated spouse made for himself or herself.

With the creation of the Roth IRA, a technical change was needed to determine the permissible contribution for the noncompensated spouse. The person using the spousal rules is eligible to contribute the lesser of $2,000 or the amount of his or her spouse's compensation as reduced by the combined amount of contributions the spouse made to a regular IRA and the Roth IRA. Before the change there was a reduction for contributions to the regular IRA only.

Change #7

Rollover contributions from a regular IRA to a Roth IRA.

The law creates a limited incentive to move money from a regular IRA to a Roth IRA. There are two ways this movement can take place. First it can happen as a rollover (i.e. a distribution and a redeposit), and all of the regular rollover rules must be satisfied. Second it can happen as a "conversion." The IRS will need to define what needs to happen to have a conversion. Will a written irrevocable instruction be sufficient? Will a Roth IRA plan agreement need to be executed? The IRS will need to provide guidance.

The movement of funds from the regular IRA to the Roth IRA will be treated as a distribution for federal income tax purposes. That is, the accountholder will have to include in his or her income the amount of the distribution. Congress has created a special incentive for just one year. If the rollover from the regular IRA to the Roth IRA occurs in 1998, then the amount of this distribution shall be divided by four, and such amount

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Schedule of Income Limits

Year	Schedule for Singles	Change	Schedule for Married	Change
1997	25,000 - 35,000	N/A	40,000 - 50,000	N/A
1998	30,000 - 40,000	5,000	50,000 - 60,000	10,000
1999	31,000 - 41,000	1,000	51,000 - 61,000	1,000
2000	32,000 - 42,000	1,000	52,000 - 62,000	1,000
2001	33,000 - 43,000	1,000	53,000 - 63,000	1,000
2002	34,000 - 44,000	1,000	54,000 - 64,000	1,000
2003	40,000 - 50,000	6,000	60,000 - 70,000	6,000
2004	45,000 - 55,000	5,000	65,000 - 75,000	5,000
2005	50,000 - 60,000	5,000	70,000 - 80,000	5,000
2006	Same	—	75,000 - 85,000	5,000
2007	Same	—	80,000 - 100,000*	5,000
Thereafter	Same	—	Same	—
Total Change		25,000		40,000

*Note that the phaseout range widens to $20,000 rather than $10,000.

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shall be included in the income of the accountholder during four tax years, the year of distribution, and the next three years. It does not appear that the accountholder may choose between including it all in income in one year, but must use the four-year inclusion rule. That is, the pro rata treatment is not elected, it is mandatory. In most cases, the taxes owed will be less when one-fourth of the distribution is included in income for four years rather than 100% in one year.

Three Changes Can Be Classified as Miscellaneous Changes

Change #8

The 15% excess distribution tax and excess accumulations tax have been repealed.

The Small Business Job Protection Act of 1996 had suspended the assessment of the 15% excess distribution tax for 1997-1998. The SBJPA did not suspend the estate tax portion of this special excise tax.

The TRA of 1997 has repealed the 15% tax effective January 1, 1997, for distributions occurring after December 31, 1996, and for the excess accumulations tax for estates of those dying after December 31, 1996.

This is a very important change. There are a substantial number of IRA accountholders and pension participants who had to worry about this 15% excise tax. They no longer have to worry as long as Congress does not recreate this tax. That is, they can allow their IRAs and/or pension accounts to grow as rapidly as possible. They will need to include any amount in income when distributed, but there will no longer be a special excess distribution tax or excess accumulation tax.

Change #9

Expansion of permissible investments for IRA funds.

The general rule is that IRA funds may not be invested in "collectibles." The concept is that investing in collectibles is not as an importantly societal goal as creating investment capital. However, an exception previously had been created for certain gold and silver coins.

The law has now been changed to authorize the purchase of certain platinum coins (in addition to certain gold and silver coins) and certain gold, silver, platinum or palladium bullion. Such bullion must be in the physical possession of the IRA trustee or custodian. Such bullion must be of fineness equal to or exceeding the minimum fineness that a contract market requires for metals which may be delivered in satisfaction of a regulated futures contract.

There Are Six Technical Correction Changes with Respect to SEPs and SIMPLEs

Change #10

The law was clarified to make it clear when an IRA custodian/trustee must file a Form 990-T to report unrelated business taxable income. Under the old law it was not clear to many IRA custodians as to whether or not they needed to file a Form 990-T in the case of an IRA which owned an interest in a partnership subject to partnership level audit rules. The reason – the partnership reported taxable income whereas the criteria for filing the Form 990-T is based on having $1,000 of gross income. Apparently many IRA custodian/trustees were not filing the Form 990-T as they should have. Code section 6012 has been amended by adding a new provision which mandates that an IRA custodian file the Form 990-T using the following approach. The IRA is to treat the distributive share of the taxable income of such partnership as being its distributive share of items of gross income.

Change #11

The SBJPA of 1996 had added the requirement that the IRA custodian of the SIMPLE-IRA must furnish a report (i.e. statement) within 30 days of the end of each calendar year to each SIMPLE-IRA accountholder. This has now been corrected to be 31 days. This change is effective as of January 1, 1997.

Change #12

As you know, SAR-SEPs were repealed. That is, those employers who maintained a SAR-SEP as of December 31, 1996, could continue to maintain such SAR-SEP, but the right to establish new SAR-SEP plans was taken away for those employers who did not maintain a SAR-SEP as December 31, 1996. However, the law as written was somewhat unclear as to how this "takeaway" applied to the person who maintained a "salary reduction" IRA. There has been a technical change so that it is clear the law change only applied at the employer level and not at the individual level. This change is effective as of January 1, 1997.

Change #13

SBJPA of 1996 had required that the SIMPLE-IRA custodian/trustee had the duty to provide a summary description with respect to the SIMPLE-IRA. A technical correction has been made to make clear that this same duty applies to an issuer of a SIMPLE-IRA annuity. This change is effective as of January 1, 1997.

Change #14

SBJPA of 1996 had created the rule that an employer could not maintain a SIMPLE-IRA plan if the employer had maintained a qualified plan with respect to which contributions had been made or benefits accrued, for service in any year in the period beginning the effective date of the SIMPLE-IRA and the last day of such year. Two exceptions have been created.

First, if the employer maintains a qualified plan which covers only union employees or certain airline pilots, then the employer may sponsor a SIMPLE-IRA plan for its employees who are not union employees or certain airline pilots. This change is effective as of January 1, 1997.

Second, if an employer has established an IRA which owned a SIMPLE-IRA plan and subsequently fails to satisfy some rules because of an acquisition, disposition or similar transaction, then rules similar to the rules which apply to qualified plans shall be applied. That is, the plan will not lose its tax-favored status. This change is effective as of January 1, 1997. This change is not as clear as would be desired.

Change #15

The maximum contribution to a SIMPLE-IRA is not the lesser of 100% of compensation or $2,000. The limit has now been defined to be the maximum amount which a person may electively defer plus the employer's contribution. This change is also effective as of January 1, 1997.

Change #16

It was unclear under the SBJPA of 1996 whether partners or other self-employed people who were participants in a SIMPLE-IRA plan were entitled to make the full elective deferral plus receive the employer's match, or whether the matching contribution was deemed to be an elective deferral.

The law has been clarified. A self-employed person as well as any other SIMPLE-IRA participant may electively defer $6,000 and then, if applicable, receive a matching contribution of $6,000 from the employer. This change is effective as of January 1, 1997. Keep in mind that the 15% deduction limits of Code section 404 do not apply to a SIMPLE-IRA. Accordingly, an employer, including a one-person business, may deduct all of the elective deferrals, and nonelective contributions or matching contributions which are made to a SIMPLE-IRA. PD