THE Pension Digest

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Proposed Technical Corrections for the Roth IRA

The IRS and Congress have concluded that a loophole exists in the rules which allow a regular IRA to be converted or rolled over into a Roth IRA.

The following situation could occur under the Roth rules as enacted in The Taxpayer Relief Act of 1997. Mary Taxpayer is age 48. She has a regular IRA with a balance of $60,000. She has adjusted gross income of less than $100,000. She chooses to convert her regular IRA to a Roth IRA in 1998. She will be required to include $15,000 ($60,000/4) in income for tax years 1998, 1999, 2000 and 2001. The law as written expressly says that the 10% pre-age 59 1/2 excise tax does not apply to this transaction (i.e. the rollover or conversion). Once the $60,000 is within the Roth IRA, Mary Taxpayer is free to withdraw her basis first. Thus, she has accomplished two tax goals which the IRS does not like. She has found a way to avoid the 10% excise tax, and she has spread the income over four tax years.

The IRS and Congress have concluded that too many people in Mary Taxpayer's situation will avail themselves of this perceived loophole. That is, they will use the Roth IRA as a means of withdrawing their IRA funds and paying substantially fewer taxes than they should.

The House Ways and Means Committee has already approved a bill which would make a technical correction and plug this perceived loophole. This bill will be considered by the full House and the Senate in the near future.

The bill as approved by the House Ways and Means Committee would modify the law so that any distribution of basis (i.e. converted amounts) within a five-year period following the conversion would be subject to the 10% excise tax. In addition, a new 10% excise tax would be assessed if the conversion or rollover occurred in 1998 so that the recipient was able to use the four-year income inclusion rule.

At this time, this is the only technical correction which is being given serious discussion. PD

Two Roth IRA Tax-Planning Tips

Planning Technique #1. The IRS strongly recommends that funds moved via rollover or conversion from a traditional IRA to a Roth IRA be kept separate from annual contributions. The reason—determining the tax consequences of any distribution from "non-combined" Roth IRAs will then be easy. Tax calculations for combined accounts will not be easy if a withdrawal takes place before the five years has run on the rollover/conversion because of the two special 10% excise taxes that most likely will apply.

Planning Technique #2. Many people in the 20-48 age bracket have never made a regular IRA contribution because they have been active participants and their contributions, if made, would have been nondeductible. Such people may now wish to make a nondeductible contribution for 1997 and then convert this IRA to a Roth IRA in 1998. There would be no taxes owing for this conversion. The effect is that a person has made a Roth Contribution in 1997 for 1998. If this person also makes a $2,000 contribution for 1998, he or she will have been able to contribute $4,000 rather than $2,000. PD

Possible Expansion of Education IRA Accounts

The political war is still going quite strongly in Congress. Bill Archer (R-Texas) is the chairman of the House Ways and Means Committee. This committee, by a 19-17 vote, has approved the Education Savings Act for Public and Private Schools. This bill would allow parents, grandparents and others to contribute up to $2,000 a year to an Education IRA. These Education IRAs would be used to pay expenses for primary and secondary education. The current Education IRA may only be used for post-secondary expenses. President Clinton has vowed to fight this expansion of the Education IRA. He most likely will veto any such bill. PD

Also in this issue –

IRS Issues 1998 COLAs

IRS Announces Cost-of-Living Adjustments for 1997
The IRS in News Release 97-41 Released its 1998 Adjustments as Follows:

	1996	1997	1998
Taxable Wage Base	62,700	65,400	68,400
SEP and Qualified Plan Maximum Compensation Cap	150,000	160,000	160,000
Excess Distribution Tax Threshold	155,000	N/A Law Changed Retroactively	N/A
Elective (Salary) Deferral Limit – 401(k) & SAR-SEP	9,500	9,500	10,000
Highly-Compensated Employees (Compensation as Indexed)			
Compensation in excess of $75,000	100,000	N/A	N/A
Compensation in excess of $50,000/Top Paid Group	66,000	N/A	N/A
New Definition as of January 1, 1997	N/A	80,000	80,000
Defined Benefit Limit — Section 415(b)	120,000	125,000	130,000
Defined Contribution Limit — Section 415(c) (The annual defined contribution plan limit is $30,000 as indexed and will not change until the defined benefit amount exceeds $120,000.)	30,000	30,000	30,000
SEP Minimum Compensation Threshold	400	400	400
Officer Amount — Top Heavy	60,000	62,500	65,000
Top 10 Owner Group — Top Heavy (Has more than one-half percent and the largest ownership interest and income in excess of $30,000.)	30,000	30,000	30,000
1% Owner — Top Heavy (Having annual compensation in excess of $150,000.)	150,000	150,000	150,000
Simple Contribution Limit	N/A	6,000	6,000

Penalty-Free Withdrawals from IRAs for Higher Education Expenses

The IRS has issued Notice 97-53 to provide initial guidance on what educational expenses will qualify for exemption from the 10% pre-age 59 1/2 excise tax. Not all education expenses qualify.

This notice addresses the question of when the education must be incurred for it to be eligible to be exempted. *Do expenses incurred in 1997 qualify, if paid in 1998?* **No.**

Based upon the Conference Report, the IRS has adopted a two-fold rule. First, the expenses must be paid after December 31, 1997. Second, the expenses must arise for education provided in academic periods beginning after December 31, 1997.

If an academic period commences in September of 1997, and ends on January 31, 1998, then a person's withdrawal from his IRA to pay such expenses would not qualify to receive the exemption for the 10% excise tax because the academic period did not start after December 31, 1997.

Remember that the exception for educational expenses is limited to the qualified higher educational expenses of the taxpayer, the taxpayer's spouse, or any child or grandchild of the taxpayer or spouse.

The pertinent portions of this Notice are set forth:

The exception for educational expenses is limited to the qualified higher education expenses of the taxpayer, the taxpayer's spouse, or any child or grandchild of the taxpayer or spouse.

Section 203 is effective for IRA distributions made after December 31, 1997, with respect to expenses paid after that date, for education provided in academic periods beginning after that date. An "academic period" includes a semester, trimester, quarter, or other academic term designated by the educational institution. For this purpose, an academic period begins on the first day of classes, and does not include periods of orientation, counseling or vacation.

For example, assume the 1997-1998 schedule of a college or university divides the academic year into two semesters; the first semester begins in September 1997, and the second semester begins in January 1998. The benefits are not available for the September semester. The benefits of section 203 would be available, however, for the qualified expenses for the semester that begins in January 1998, provided the IRA distribution is made after December 31, 1997, and the expenses are paid after that date. This result applies to students who are enrolled in both semesters as well as to students whose enrollment begins only with the January semester. PD

Education IRA Accounts or Education IRA Annuities?

Internal Revenue Code section 530, as currently written, authorizes only education individual retirement accounts; it does not authorize Education IRA annuities.

Insurance companies who wish to offer this product will need to either have the law change, obtain approval as a nonbank trustee under existing IRS procedures, or determine that the last phrase of section 530(b)(1)(B) provides them the necessary authority.

Code section 530(b)(1)(B) reads as follows:

(B) The trustee is a bank (as defined in section 408(n)) or another person who demonstrates to the satisfaction of the Secretary that the manner in which that person will administer the trust will be consistent with the requirements of this section or who has so demonstrated with respect to any individual retirement plan. *(We have underlined the word "plan" because it can be strongly argued an "IRA plan" includes an annuity whereas an account does not.)*

The IRS has recently issued Notice 97-57. The third section of this notice reads as follows:

(3) Approval of nonbank trustees and custodians.

Under section 530 of the Code, the trustee or custodian of an Education IRA must be a bank (as defined in section 408(n) of the Code) or another person approved by the Internal Revenue Service. Section 1.408-2(e) of the Income Tax Regulations sets forth the rules which an entity must meet to be approved by the Service as a nonbank trustee or custodian of an individual retirement account (IRA). Pursuant to this notice, any entity already approved by the Service to be a nonbank trustee or custodian of an IRA is automatically approved by the Service to be a nonbank trustee or custodian of an Education IRA. In addition, entities other than banks or previously approved nonbank IRA trustees or custodians may request approval to be a trustee or custodian of an Education IRA in accordance with the procedures set forth in section 1.408-2(e) and section 3.10 of Rev. Proc. 97-4, 1997-1 I.R.B. 97, dated January 6, 1997. PD

Update on Medical Savings Account

The IRS has issued Announcement 97-96 to discuss the numerical limits which apply to Medical Savings Accounts (MSAs).

These numerical limits are complicated. This article attempts to explain these limits and explains other developments with MSAs. This author believes that many small employers will shift to MSAs from standard group health insurance once there is a better understanding of all the rules and attributes.

The limits are annual limits. There are different limits for 1997, 1998, 1999, and 2000.

In authorizing the creation of MSAs, Congress placed a limit on the number of MSAs which could be established. There was a real political war between the Republicans and Democrats over MSAs. The opponents of MSAs argue that such plans will destroy group insurance plans as all of the healthy and wealthy people will opt for MSAs. Those remaining (the sick, poor and elderly) will then have to pay higher insurance premiums, and they most likely will be unable to afford such insurance.

Congress devised the concept of a cut-off year. If a year is a cut-off year, then a person will not qualify for an MSA for any taxable year beginning after such cut-off year unless: (a) such person was an active participant for any tax year ending on or before the the cut-off date of the cut-off year, or (b) such person becomes an MSA participant after the cut-off year by reason of his or her becoming covered under an existing high-deductible health plan of an MSA participating employer. The general rule is that the cut-off date is October 1 of the cut-off year. There are some exceptions to this rule. The cut-off date for a self-employed individual is November 1.

In the statute, Congress has defined the cut-off year to be the earlier of: a cut-off year earlier than the year 2000, or the year 2000.

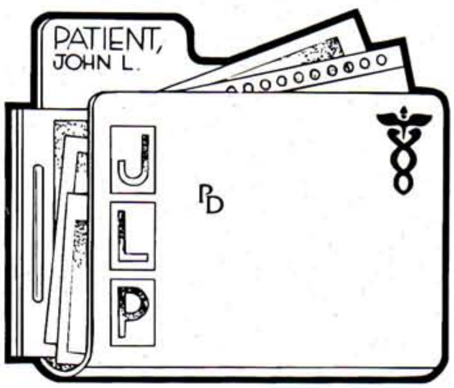
The 1997 Limit

The numerical limit for 1997 would have been exceeded (and then 1997 would have been a cut-off year) if either of two numerical limits had been exceeded: (a) more than 375,000 as of April 30, 1997, or (b) 525,000 as of June 30, 1997.

The IRS has determined that the applicable number of MSAs established as of June 17, 1997, is 17,145. Therefore, October 1, 1997 is not a cut-off date, and 1997 is not a cut-off year.

The IRS makes the following statement within Announcement 97-96.

> Based on Forms 8851 filed by MSA trustees and custodians, it has been determined that 22,051 taxpayers have established MSAs as of June 30, 1997. Of this total, 3,670 taxpayers were reported as previously uninsured, and are therefore not taken into account in determining whether 1997 is a "cut-off" year. In addition, 1,236 taxpayers were reported as excludable from the count because their spouse also established an MSA. Accordingly, because the applicable number of MSAs established as of June 30, 1997, 17,145 (22,051 minus (3,670 plus 1,236)) is less than 25,000, 1997 is not a "cut-off" year for the MSA pilot project.



The 1998 Limits

There are two limits for 1998 — either one may result in 1998 being a cut-off year.

The first numerical limit for 1998 will be exceeded (and then 1998 will be a cut-off year) if 600,000 is less than the sum of (a) the number of MSA returns filed for 1997 on or before April 15 of such calendar year for taxable years ending with or within 1997 plus (b) the Secretary's estimate of the number of MSA returns for such taxable years which will be filed after such date. The term "MSA return" means any return on which any exclusion is claimed under section 106(b) or any deduction claimed under section 220.

The second numerical limit for 1998 will be exceeded (and then 1998 will be a cut-off year) if 750,000 is less than the sum of (a) 90% of the sum determined in the preceding paragraph plus (b) the product of 2.5 times the number of MSAs established from January 1, 1998, to June 30, 1998, as reported by the trustee on the Form 8851 no later than August 1, 1998.

The 1999 Limits

There are also two limits for 1999 — either one may result in 1999 being a cut-off year.

The first numerical limit for 1999 will be exceeded (and then 1999 will be a cut-off year) if 750,000 is less than the sum of (a) the number of MSA returns filed for 1998 on or before April 15 of such calendar year for taxable years ending with or within 1998 plus (b) the Secretary's estimate of the number of MSA returns for such taxable years which will be filed after such date. The term "MSA return" means any return on which any exclusion is claimed under section 106(b) or any deduction claimed under section 220.

The second numerical limit for 1999 will be exceeded (and then 1999 will be a cut-off year) if 750,000 is less than the sum of (a) 90% of the sum determined in the preceding paragraph plus (b) the product of 2.5 times the number of MSAs established from January 1, 1999, to June 30, 1999, as reported by trustee on the Form 8851 no later than August 1, 1999.

A Comprehensive Study of MSAs. In passing the law authorizing a limited number of MSAs, Congress mandated that there be a comprehensive study of MSAs. One part of this study was to be a demographics study to be conducted by the General Accounting Office. This demographics study has been put on hold until more MSAs have been established. The demographics survey is to use random digit dialing to examine the characteristics of people with and without MSAs as their health insurance plan. The second part of the study is to be a survey of insurance companies as to how marketing of MSAs is proceeding. PD

A New Type of MSA

MEDICARE+CHOICE MSA

Congress has devised another type of MSA, the Medicare+Choice MSA. This new MSA will be available as of January 1, 1999 (not 1998). Congress enacted Code section 138 to authorize this new type of MSA.

The Medicare+Choice MSA is a standard MSA which is designated as a Medicare+Choice MSA.

Contributions to a person's Medicare+Choice MSA will be made by the Secretary of Health and Human Services. The Secretary will contribute an amount equal to the deductible amount under health care coverage provided to the account owner by the Medicare+Choice Plan. This transfer of funds to an MSA of the account owner will not be included in the person's income at the time the contributions are made.

As with regular MSAs, distributions from the Medicare+Choice MSA can be used by its owner to pay for qualifying medical expenses, with no tax imposed on such withdrawals.

If withdrawals are used for nonqualifying medical expenses, then the distribution will be included in income and may be subject to a 50% penalty tax. The 50% penalty tax will not apply if the Medicare+Choice MSA account balance exceeds 60% of the deductible of the plan under which the person is covered or after the death or disability of the account owner.

Upon the death of the account owner, if the beneficiary is the spouse, then the Medicare+Choice MSA converts to be the spouse's regular MSA.

Upon the death of the account owner, if the beneficiary is a nonspouse, then the Medicare+Choice MSA account balance is to be included in the income of the beneficiary for the tax year in which the death occurred. PD

SIMPLEs — An Important Reminder

1. The deadline for establishing a SIMPLE for 1997 was October 1, 1997, unless the business wishing to establish the SIMPLE did not come into existence until after October 1, 1997. A business coming into existence after October 1, 1997 may still establish a SIMPLE plan.

2. A SIMPLE plan by law must have a calendar year plan year. That is, the plan year runs from January 1 to December 31. An employer with a fiscal year may establish a SIMPLE, but this employer should understand that it is entitled to claim a tax deduction for its contribution for the tax year with which or within which the SIMPLE year ends.

Example. A business has a fiscal or tax year of October 1, 1996, to September 30, 1997. Any SIMPLE contributions made in 1997 will not be deductible on that tax return. The 1997 SIMPLE plan year ends on December 31, 1997, and therefore the employer will be able to deduct such contributions for the year which ends September 30, 1998.

3. When a business signs the Form 5305-SIMPLE, there is a financial institution which is designated as the designated financial institution. If your institution serves as the designated financial institution, then once each year you must provide your business customer with a summary description. If you have not furnished this summary description for the upcoming 1998 SIMPLE year, you should do so as soon as possible. The employer will then need to furnish a summary description to each eligible employee.

4. A self-employed person will be entitled to claim a tax deduction for his or her SIMPLE contribution if the following rules are met: (a) the Form 5305-SIMPLE was signed on or before October 1, 1997; (b) he or she has signed an elective deferral form stating what portion of his or her income will be deferred — this instruction may be changed up through December 31, 1997, but cannot be changed after such date.

5. Many small businesses are going to want SIMPLE plans. These will be businesses which have never had a plan, and they will be businesses who are fed up with the complexities and expenses of 401(k) plans. We would suggest that it is in your best interest to tell your customers you are ready to serve them with respect to SIMPLEs rather than them having to ask you.

6. You should review the February, 1997 newsletter if you want a reminder regarding the fees you may charge SIMPLE plans and SIMPLE-IRA accountholders. PD

✔Check It Out

Question: May an owner of a business contribute to both her SIMPLE-IRA and a Roth IRA in 1998? Or, could she contribute to her SIMPLE-IRA, traditional IRA, and Roth IRA?

✔ Answer. A SIMPLE-IRA is an employer-sponsored retirement plan. Thus, the amount contributed under such a plan does not affect the amount a person is eligible to contribute to a Roth IRA or a traditional IRA. A person may contribute to a SIMPLE-IRA, regular IRA, and/or a Roth IRA as long as the respective eligibility requirements are met.

Question: Has the tax rate for a prohibited transaction changed?

✔ Answer. Yes. In 1996, the Small Business Jobs Protection Act of 1996 changed the rate from 5% to 10%. In 1997, the Taxpayer Relief Act of 1997 changed the rate from 10% to 15%. This was effective with respect to prohibited transactions occurring after August 5, 1997. Keep in mind that when a prohibited transaction occurs with respect to an IRA, the IRA is deemed distributed and becomes taxable unless a portion of the IRA is the return of basis. This distribution is subject to the 10% pre-age59 1/2 tax, if applicable. PD

The Pension Digest invites your questions and comments. Please address to "Check It Out," Collin W. Fritz & Associates, Ltd., P.O. Box 426, Brainerd, MN 56401.