THE Pension Digest

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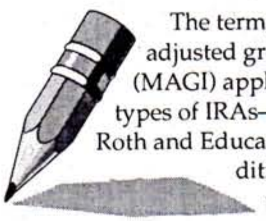
The Definition Game—Modified Adjusted Gross Income



The term, "modified adjusted gross income" (MAGI) applies to all three types of IRAs—traditional, Roth and Education. For the traditional IRA, it is used to determine, in the case of a person who is an active participant, what portion of his or her contribution is deductible. For the Roth IRA and the Education IRA, it is used to determine whether or not a person is even eligible to make a contribution and if so, how much.

The problem is—the definition of this term differs depending on the type of IRA. How one calculates MAGI is not the same for each type of IRA.

MAGI for the Traditional IRA

Code section 219 and section 408 contain the primary laws which govern a traditional IRA. As is well known, the Tax Reform Act of 1986 imposed limits as to how much a person can deduct for his or her IRA contribution based upon whether or not he or she (the spouse) is an active participant and their adjusted gross income.

Code section 219(g)(3)(A) contains the definition of adjusted gross income and reads as follows:

"(A) ADJUSTED GROSS INCOME. – Adjusted gross income of any taxpayer shall be determined–

(i) after application of sections 86 and 469, and

(ii) without regard to sections 135, 137, and 911 or the deduction allowable under this section."

Code section 86 covers social security and tier 1 retirement benefits. Code section 469 sets forth limitations on passive activity losses and credits. Code section 135 covers income from U.S. savings bonds used to pay higher education tuition and fees. This is reported on Form 8815. Code section 137 allows a deduction for certain adoption assistance programs. Code section 911 allows a citizen or resident of the United States who is living abroad to exclude, within limits, foreign earned income and foreign housing cost.

The IRS has attempted to simplify this definition and calculation. On page 11 of the IRS Publication 590, the following general statement is made, "your MAGI is the amount on the line 'adjusted gross income' as located on page 1 of your Form 1040, but modified by figuring it without taking any:

a. IRA deduction;

b. Foreign earned income exclusion;

c. Foreign housing exclusion or deduction;

d. Exclusion of series EE bond interest shown on Form 8815, or

e. Exclusion of employer paid adoption agreement shown on Form 8839."

The IRS has devised fairly complicated worksheets and schedules to show how MAGI is calculated when a person is receiving social security benefits, has received an IRA distribution and/or wishes to make a deductible IRA contribution. These are set forth in the IRS Publication 590.

With the traditional IRA, it has always been the rule that the taxable amount distributed throughout the year is added to arrive at MAGI. That is, distributions from the traditional IRA may have the result of increasing one's AGI (if an active participant) sufficiently so that he or she becomes partially or totally ineligible to claim a deduction for a traditional IRA contribution.

When funds are rolled over or converted from a traditional IRA to a Roth IRA, the amount distributed from the traditional IRA is included in one's MAGI. It appears that the person who makes such a

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States Laws - Impact On Roth and Education IRAs

State laws do impact the new Roth and Education IRAs. In many states there will be uncertainty until a state acts to adopt the same new tax laws as the federal government adopted in the Taxpayer Relief Act of 1997. The laws of some states require their respective legislatures to enact conforming tax law changes. The concept being - a state cannot delegate to the federal government the duty to revise state laws.

Other states apparently have laws which permit any federal tax law change to automatically be adopted for state law purposes.

Anytime a new tax law is passed, there is always the issue of whether or not a state will adopt the new law. There is no requirement to do so.

Most states adopt the federal tax law changes for simplicity reasons. It is easier to administer a state's tax laws when the starting point is a person's federal adjusted gross income (FAGI). Most states try to limit the number of adjustments which are made to FAGI. Taxpayers find these adjustments confusing, and a large

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Definition Game—*Continued from page 1*

rollover/conversion in 1998 will include only 25% of the distribution in his or her MAGI (and not the full 100%). Thus, by ng over funds to a Roth IRA, the person may lose the ability to deduct some or all of his or her contribution to a traditional IRA because his or her MAGI increases. In addition, the distribution from the traditional IRA may cause some social security benefits to become taxable.

MAGI for the Roth IRA

Contributions to a Roth IRA are limited based upon one's modified adjusted gross income.

Code section 408A(c)(3)(C)(i) sets forth the definition of adjusted gross income. Subsection (c) of section 408A sets forth the contribution limits which are based upon "applicable limits" and "modified adjusted gross income." The definition of adjusted gross income reads as follows:

"(i) adjusted gross income shall be determined in the same manner under section 219(g)(3), except that any amount included in gross income under subsection (d)(3) (i.e. rollovers from an IRA other than a Roth IRA) shall not be taken into account and the deduction under section 219 shall be taken into account." (The parenthetical was added.)

servations

1. The amount rolled over from a traditional IRA is not taken into account for purposes of either the $100,000 "eligibility to roll over" test or for the limits-tied annual Roth contributions (i.e. 0, $95,000 and $150,000).

2. If the person claims a tax deduction for his or her contribution to a traditional IRA, this will reduce the person's MAGI for purposes of being eligible to make a rollover (i.e. the $100,000 limit) and also for purposes of determining the amount permitted to be contributed to the Roth IRA.

Examples of MAGI for the Traditional IRA and the Roth IRA

Example #1. Claire Hunt is single and is an active participant. She has AGI from other sources of $22,000. In 1998, she decides to withdraw $20,000 from her traditional IRA and she rolls it over to a Roth IRA. Claire must include $5,000 (25% of $20,000) in income for 1998, 1999, 2000 and 2001. Thus, her MAGI for traditional IRA purposes for 1998 will be $27,000. Since she is under the base amount of 000, she will be able to deduct a contribution of $2,000 to her traditional IRA. Alternatively, she is eligible to make a $2,000 contribution to a Roth IRA. Her MAGI for Roth purposes is $22,000. She could also split the $2,000 contribution amount between a traditional IRA and a Roth IRA.

Example #2. In 1999, Claire has AGI from other sources of $24,000. She decides to withdraw and roll over an additional $6,000 in 1999. She will be required to include this $6,000 in her MAGI calculation. And she will also be required to include the $5,000 from the 1998 distribution. Thus, she has MAGI of $35,000 for traditional IRA purposes. After applying the formula:

$$2{,}000 \times \frac{35{,}000 - 30{,}000 \text{ (threshold level)}}{10{,}000} = 1{,}000$$

she qualifies to deduct $1,000 of any traditional IRA contribution. Thus, her contribution options for 1998 are: (1) make a deductible contribution of $1,000 to a traditional IRA and a nondeductible contribution of $1,000 to the traditional IRA; (2) make a deductible contribution of $1,000 to the traditional IRA and a $1,000 contribution to a Roth IRA; or (3) make a $2,000 contribution to a Roth IRA. Note that her MAGI for Roth IRA purposes is $24,000.

Example #3. Julia Kuhn is single and is an active participant. She has AGI from other sources of $94,000. She decides to withdraw $28,000 in 1998 from her traditional IRA and she rolls it over to a Roth IRA. Julia must include $7,000 (25% of $28,000) in income for 1998, 1999, 2000 and 2001.

For traditional IRA deduction purposes, her MAGI of $101,000 far exceeds the deductible base amount of $30,000. She is eligible to make a $2,000 contribution to a traditional IRA, but it would be a nondeductible contribution.

Her MAGI for purposes of the Roth IRA for 1998 is $94,000. This is true for purposes of determining whether she is eligible to make a rollover to a Roth or to make a contribution to a Roth. Because her $94,000 is less than the $100,000 rollover limit, she qualifies to roll or convert her traditional IRA funds to a Roth IRA. Because her $94,000 is less than the $95,000 limit which applies to a single person, she may make a $2,000 contribution to a Roth IRA for 1998.

The Education IRA

As with the Roth IRA, the amount which a person may contribute to an Education IRA on behalf of a designated beneficiary is limited based upon his or her MAGI (and joint MAGI in the case of a joint return).

Code section 530(c)(2) sets forth the definition for Education IRA purposes:

"(2) MODIFIED adjusted gross income. – For purposes of paragraph (1) (i.e. the ratio tests), the term 'modified adjusted gross income' means the adjusted gross income of the taxpayer for the taxable year increased by the amount excluded from gross income under section 911, 931 or 933."

This definition is different than that which applies for the traditional and the Roth IRA. Section 931 sets forth rules for income from sources within Guam, American Samoa, or Northern Mariana Islands and Section 933 sets forth rules for income from sources within Puerto Rico.

A person does still receive the benefit of any traditional IRA deduction.

As with the traditional IRA (in contrast with the Roth) there is no exclusion for Education IRA MAGI purposes for the amount withdrawn from a traditional IRA and rolled over or converted to a Roth IRA.

Example #1. Danny Lau is married to Teresa. Their combined adjusted gross income is $153,000. Each makes a $2,000 deductible IRA contribution since neither is an active participant in an employer-sponsored plan. Their combined MAC for Education IRA purposes is $149,000. They would be eligible to make IRA contributions on behalf of a designated beneficiary.

Example #2. The same Julia Kuhn example as discussed above. She had AGI from other sources of $94,000. She withdrew $28,000 in 1998 from her traditional IRA and she rolled it over to a Roth IRA. Julia must include $7,000 (25% of $28,000) in income for 1998, 1999, 2000 and 2001.

For traditional IRA deduction purposes, her MAGI was $101,000.

As mentioned above, her MAGI for purposes of the Roth IRA for 1998 is $94,000.

For purposes of the Education IRA calculations, her MAGI is also $101,000. She only qualifies to make a partial IRA contribution because her MAGI exceeds the base amount of $95,000. She could make Education IRA contributions on behalf of one or more designated beneficiaries in the amount of 6/15 x $500 or $200.

Summary. A person will need to calculate his or her MAGI separately for each type of IRA, as different rules apply. PD

Reminder—SIMPLE-IRA Plans Can Be Wonderful for Self-Employed Individuals

Small employers, including one-person businesses, were first eligible to establish SIMPLE-IRA plans on and after January 1, 1997. SIMPLE-IRA plans must be established on a calendar-year basis—1997, 1998, 1999, etc.

The basic concept of the law is—an employer must inform its employees annually that it will be sponsoring a SIMPLE-IRA plan, that it will make a matching contribution of 1-3%, and that each eligible employee may make elective deferrals in an amount not exceeding the lesser of 100% of compensation or $6,000.

A farmer, rancher or other self-employed person must now decide between a SIMPLE-IRA, SEP, Profit Sharing or Money Purchase plan. If a person funds another plan, he or she becomes ineligible to fund a SIMPLE plan. In many situations a one-person business will choose the SIMPLE-IRA plan.

The attractive features of the SIMPLE-IRA are:

1. There is no contribution percentage limit for a SIMPLE-IRA as there is with a profit sharing plan (15% of compensation), SEP plan (15% of compensation) and a money purchase plan (25%).

For example, a farmer with net earnings of $24,000 could contribute $6,000 plus a 3% match for a total contribution of $6,720. Under a profit sharing plan the 15% limit would apply, the special compensation limit would apply, and therefore the maximum contribution amount would be $3,010.

There are some taxpayers who have previously-acquired wealth and could still afford a $6,720 contribution on net earnings of only $24,000.

2. This lack of a contribution limit will influence taxpayers to reconsider whether they should split income between a husband and a wife. Previously, the law influenced a couple to allocate all of a business's net earnings to one of the spouses rather than to split it. Rather than pay the self-employment (social security) tax by both spouses, the income was allocated to just one spouse and then the social security portion of the tax was ended at the taxable wage base amount (i.e. $62,400).

The SIMPLE creates an incentive to now allocate some of the net earnings to the other spouse.

For example, in the above situation, if $18,000 was allocated to the husband and $6,000 to the spouse, then each could defer $6,000, plus each would receive the 3% match. Total deductible contribution in this situation would be $12,720.

Again, there are some taxpayers who have previously-acquired wealth and could still afford a $12,720 contribution on joint net earnings of only $24,000.

3. The sponsoring employer is not required to prepare any Form 5500 for the SIMPLE-IRA plan.

4. Arguably, it is easier for an employer and the employees to determine who must be covered under the plan since the requirement is based upon compensation earned in the prior two years.

5. There is no requirement that an employer use the SIMPLE-IRA plan each and every year. The employer can choose from year to year as to whether it wants to use a profit sharing plan or a SIMPLE-IRA plan. In very good years, an employer most likely would like to use a profit sharing plan since it would allow for a much larger contribution. However, there is a major limitation. The employer must make its decision before the year starts and not mid-year or after the end of the year. PD

State Laws—*Continued from page 1*

amount of noncompliance results because quite a few taxpayers and tax preparers are not well versed in the fact that different rules apply at the federal and state levels.

Most states will adopt all of the new federal laws regarding Roth IRAs and Education IRAs. Some states will adopt only a portion of the new federal tax laws. And a few may not adopt any of the new laws. An IRA accountholder must understand the laws of his or her state.

The possible tax uncertainties are:

1. Amounts withdrawn from the traditional IRA and rolled over/converted in 1998 receive, at the federal level, the special tax treatment that 25% of the amount distributed is taxed in 1998, 1999, 2000 and 2001. This is a type of income averaging.

A state could choose to tax the entire distribution in 1998 or it could choose to do the four-year averaging approach.

2. If the recipient is under age 59 1/2, then the 10% excise tax is not assessed unless the proposed technical corrections are enacted. A state may or may not choose to assess the 10% excise tax in the same fashion.

3. The earnings of a Roth or Education IRA would be taxable at the state level if there is no conforming law enacted. Such earnings would be reportable to the state but not the IRS. Conversely, distributions would not be taxable, and therefore Form 1099-Rs would not apply at the state level.

Conclusion. Some traditional IRA accountholders will wish to wait until later in the year, after the state tax law issues have been settled, to transact their rollover/conversion. PD

Discussion of 1997 Form 5500-EZ and Schedule P

Who Uses the Form 5500-EZ?

The Form 5500-EZ can be used for a one-person retirement plan if the person sponsoring the plan meets all of the following conditions:

1. The plan is a one-participant plan. If the sponsoring business is a sole proprietorship, then the plan may cover only the owner of the business and his or her spouse. If the sponsoring business is a partnership, then the plan may cover only one or more partners (and spouses).

2. The plan meets the section 410(b) coverage rules without having to be combined with any other plan sponsored by the same sponsor.

3. The plan does not provide benefits for anyone who is not a participant.

4. The plan does not cover a business that is a member of a group of businesses under common control, a controlled group of corporations or an affiliated service group.

5. The plan does not cover a business which leases employees.

If all five of these conditions are not met, then the sponsoring business must file the Form 5500-C/R.

Who Does Not Need to File the Form 5500-EZ or the Form 5500-C/R?

No filing is necessary if the plan sponsor meets the five requirements listed above and if the plan sponsor had one or more plans that had total plan assets of $100,000 or less at the end of every plan year ending after January 1, 1994.

Which One-Participant Plans Must File the Form 5500-EZ?

A one-participant plan must file the Form 5500-EZ if the plan sponsor had one or more plans that had total combined plan assets of more than $100,000 at the end of any plan year ending after January 1, 1994.

A one-participant plan which is required to file the Form 5500-EZ must complete and file it for the first year which is required and then for every year thereafter. That is, it is no longer possible to file a Form 5500-EZ and then not file one for the next year.

A special rule applies to terminating plans. All one-participant plans must file a Form 5500-EZ for their final plan year even if total plan assets have always been less than $100,000. The final plan year is the year in which distribution of all plan assets is completed.

Changes in Filing Rules Summarized

For 1994 and prior years, one-participant plans that held $100,000 or less in total plan assets at the end of any plan year did not have to file the Form 5500-EZ (or any other information return) for that plan year. For 1995 and later years, one-participant plans that held more than $100,000 at the end of any plan year beginning on or after January 1, 1994, must file a Form 5500-EZ for the year the assets exceeded $100,000 and for each year thereafter, even if total plan assets were reduced to $100,000 or less at a later date. For example, if plan assets in a plan that otherwise satisfies the requirements for filing the Form 5500-EZ totaled $110,000 at the end of the 1994 plan year, and a distribution occurred in 1995 so that total plan assets were $85,000 at the end of the 1995 plan year, a Form 5500-EZ must be filed for the 1995 plan year and all future years.

Penalties for Failing to File

The IRS imposes a penalty of $25 a day (up to $15,000) for not filing this form.

Where to File

This form is filed with the IRS Service Center in Memphis, Tennessee 37501-0024.

Filing Deadline

For most people, the deadline is July 31, 1998. Technically, the deadline is the last day of the seventh month following the end of the plan year. It is possible to obtain an extension by filing Form 5558. A 2 1/2 month extension may be obtained.

Explanation

The IRS has furnished a sample and a supplemental explanation. These are set forth on the enclosure along with the Schedule P. The 1997 form is very similar to the previous years' forms. Most items on the form are self-explanatory. But here are a few comments.

1. Line 4(a). The person must furnish the opinion letter number which the IRS has issued to the financial institution if the person is using an institution's prototype. This is an audit question. If the institution has an "old" prototype (i.e. one with an opinion letter before June of 1990), the IRS will be contacting the person. Remember, plans must be updated in a timely fashion by both the institution sponsoring the prototype and also by the business person. The institution must update its prototype, and the customer must timely adopt this updated prototype.

2. Line 4(b) asks if this plan covers self-employed persons, partners, or a 100% owner of a corporation. The IRS wants to be able to determine to which of these categories the person belongs.

3. Line 7(a), about fully-insured plans, will not apply to most plan sponsors unless they have established the plan with an insurance company.

4. Line 7(b) and 7(c) deal with contributions. Plan contributions should be in cash. Question 7(c) is asking if there were any noncash contributions (an audit question).

5. Line 7(d) asks for the amount of plan distributions to participants or beneficiaries. This includes amounts rolled over whether by use of Code section 401(a)(31) or not. If the plan distributes an asset other than cash, include the current value (i.e. fair market value) at the time of distribution. However, when an annuity or an insurance contract is distributed, insert the cash value at the time of distribution.

6. Line 7(e) asks for the amount of those distributions which are nontaxable. Examples would be — the return of non-deductible employee contributions, and payments which qualify for the death-benefit exclusion.

7. Line 7(f) asks for the amount of transfers to other plans. The IRS means "transfers" under Code section 414(l) and not direct rollovers which are treated as distributions.

8. Line 7(g) asks for the amounts received by the plan for reasons other than the standard employer contributions. Examples are – rollover contributions, direct rollover contributions, transfers and the receipt of earnings on plan investments.

9. Line 10 asks if there are other employees. Having additional employees is not necessarily a sign the plan sponsor is doing anything wrong. The IRS might check later to see if the plan sponsor has covered these employees properly.

10. Line 11(b) asks if there were any distributions in a form other than a QJSA (qualified joint and survivor annuity). The form of payment must be a QJSA unless special waivers are executed or the plan is a profit sharing plan which is not subject to the QJSA rules. Many people will need to answer this question "yes." Example, a person was paid a lump-sum distribution from a profit sharing plan; a person was paid a lump-sum distribution from a money purchase plan after receiving the spouse's waiver; a person was paid a partial distribution from a profit sharing plan; or a person was paid a partial distribution from a money purchase plan after receiving the spouse's waiver.

11. Line 11(c) asks if there were any loans to married participants. Although most people with profit sharing and money purchase Keoghs understand that they themselves cannot borrow from their plan, sometimes they are unaware that they cannot make loans to their spouses.

Summary

The filing requirements for the 1997 Form 5500-EZ have changed very little from 1996. If your financial institution does not assist with the preparation of the Form 5500-EZ, then we would suggest you send a reminder notice to your business customers enabling them to determine whether the 1997 Form 5500-EZ must be filed. The IRS still takes the position that the Schedule P may only be filed as an attachment to the Form 5500-EZ, and it may not be filed separately. And remember, those employers with more than one participant are required to file either the Form 5500-C/R or Form 5500. PD

SCHEDULE P (Form 5500)

Department of the Treasury Internal Revenue Service

Annual Return of Fiduciary of Employee Benefit Trust

► File as an attachment to Form 5500, 5500-C/R, or 5500-EZ.

► For the Paperwork Reduction Notice, see the Form 5500 instructions.

OMB No. 1210-0016

1997

This Form Is Open to Public Inspection.

For trust calendar year 1997 or fiscal year beginning , 1997, and ending , 19 .

Please type or print

1a Name of trustee or custodian

b Number, street, and room or suite no. (If a P.O. box, see the instructions for Form 5500, 5500-C/R, or 5500-EZ.)

c City or town, state, and ZIP code

2a Name of trust

b Trust's employer identification number

3 Name of plan if different from name of trust

4 Have you furnished the participating employee benefit plan(s) with the trust financial information required to be reported by the plan(s)? . . . . ☐ **Yes** ☐ **No**

5 Enter the plan sponsor's employer identification number as shown on Form 5500, 5500-C/R, or 5500-EZ . . . . ►

Under penalties of perjury, I declare that I have examined this schedule, and to the best of my knowledge and belief it is true, correct, and complete.

Signature of fiduciary ► **Date ►**

Instructions

Section references are to the Internal Revenue Code.

Purpose of Form

You may use this schedule to satisfy the requirements under section 6033(a) for an annual information return from every section 401(a) organization exempt from tax under section 501(a).

Filing this form will start the running of the statute of limitations under section 6501(a) for any trust described in section 401(a), which is exempt from tax under section 501(a).

Who May File

1. Every trustee of a trust created as part of an employee benefit plan as described in section 401(a).

2. Every custodian of a custodial account described in section 401(f).

How To File

File Schedule P (Form 5500) for the trust year ending with or within any participating plan's plan year. Attach it to the Form 5500, 5500-C/R, or 5500-EZ filed by the plan for that plan year. A separately filed Schedule P (Form 5500) will not be accepted.

If the trust or custodial account is used by more than one plan, file one Schedule P (Form 5500). If a plan uses more than one trust or custodial account for its funds, file one Schedule P (Form 5500) for each trust or custodial account.

Trust's Employer Identification Number

Enter the trust employer identification number (EIN) assigned to the employee benefit trust or custodial account, if one has been issued to you. The trust EIN should be used for transactions conducted for the trust. If you do not have a trust EIN, enter the EIN you would use on Form 1099-R to report distributions from employee benefit plans and on Form 945 to report withheld amounts of income tax from those payments.

Note: *Trustees who do not have an EIN may apply for one on **Form SS-4,** Application for Employer Identification Number. You must be consistent and use the same EIN for all trust reporting purposes.*

Signature

The fiduciary (trustee or custodian) must sign this schedule. If there is more than one fiduciary, the fiduciary authorized by the others may sign.

Other Returns and Forms That May Be Required

- **Form 990-T—**For trusts described in section 401(a), a tax is imposed on income derived from business that is unrelated to the purpose for which the trust received a tax exemption. Report this income and tax on **Form 990-T,** Exempt Organization Business Income Tax Return. (See sections 511 through 514 and the related regulations.)
- **Form 1099-R—**If you made payments or distributions to individual beneficiaries of a plan, report those payments on Form 1099-R. (See the instructions for Forms 1099, 1098, 5498, and W-2G.)
- **Form 945—**If you made payments or distributions to individual beneficiaries of a plan, you may be required to withhold income tax from those payments. Use **Form 945,** Annual Return of Withheld Federal Income Tax, to report taxes withheld from nonpayroll items. (See **Circular E,** Employer's Tax Guide (Pub. 15), for more information.)