THE Pension Digest

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President Clinton Signs the IRS Restructuring and Reform Act on July 22, 1998

The way that the IRS has conducted business will be changing dramatically. The IRS is being forced to become more "customer/client/taxpayer" friendly.

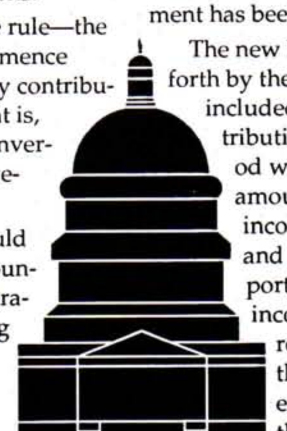
The reason this newsletter (an IRA and pension newsletter) is discussing this IRS Restructuring and Reform Act is because, in addition to the restructuring provisions, the bill contains a number of technical corrections for Roth IRAs, traditional IRAs and Education IRAs.

Although we discussed these technical corrections in some detail in the May newsletter, we discuss them again now because they are no longer proposals, they are law. Except as specifically indicated below, these law changes will be retroactively effective as of 1-1-98 (i.e. as if included in the 1997 Act and apply to taxable years beginning after 12-31-97).

Rule Changes Regarding Conversion of Traditional IRAs into Roth IRAs

1. Under prior law, there were separate five-year "holding" requirements for regular Roth contributions and Roth rollover/conversion contributions.

The new law is a very simple rule—the five-year holding rule will commence with the first year for which any contribution to a Roth IRA is made. That is, subsequent contributions or conversions would not have a new five-year period.



Marketing Tip. A bell should go off. Every taxpayer in the country should give serious consideration to establishing and funding a Roth IRA, even if the contribution is only a nominal amount, in order to start the clock running for purposes of the five-year requirement. The sooner it starts to run, the sooner the time period requirement will be met. For example, all potential first-time home buyers should have a Roth IRA.

2. Application of the four-year spread or averaging rule would be elective and not mandatory for Roth conversions/rollovers completed in 1998. The taxpayer has the right to elect whether he or she will use the spread approach or will include all of the distribution in income for 1998 tax purposes. A person is considered to have elected the four-year spread method unless he or she expressly elects to include the entire taxable portion of the distribution in income in 1998.

The election becomes irrevocable after the due date of the tax return for the year the conversion occurred.

3. Under prior law, a person could have received the tax benefit of spreading his or her income realized from the distribution from the traditional IRA over four years. Congress believes there needs to be a recapture rule if a person uses the spread method and then withdraws funds from the Roth IRA before the four-year requirement has been met (i.e. 12-31-2001).

The new law adopts the approach put forth by the Senate. The amount to be included in income for an early distribution during the four-year period would be the sum of: (1) the amount otherwise includable in income under the four-year rule; and (2) the lesser of the taxable portion of the withdrawal (and income comes out first), or the remaining taxable portion of the conversion. The following example has been provided by the joint staff:

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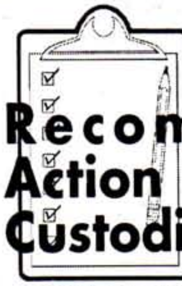

1998 Tax Law Changes

Recommended Action by an IRA Custodian/Trustee

The other article on this page discusses the law changes made by the 1998 tax legislation. As an IRA custodian/trustee, you will now want to understand what administrative actions you must or should consider taking. We see no reason why you must rush into action from a compliance viewpoint, but there may be cause to act promptly for marketing and customer-service purposes. You will need to decide your own time table for adopting and implementing these law changes. In general, we would recommend that amendments be furnished on or before January 31, 1999 (i.e. the deadline for IRA Fair Market Value Statements). However, you may wish to furnish the Roth IRA and Education IRA amendments in 1998 because the Roth IRA accountholders and the Education IRA designated beneficiaries may appreciate being informed of their "new" rights as early as possible.

Data Processing. The 1998 law changes do not require any additional changes for Roth IRAs and Education IRAs than what was required because of the 1997 law changes, with one exception. It now appears that there may be designated an

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"Example: Taxpayer A has a nondeductible IRA with a value of $100 (and no other IRAs). The $100 consists of $75 of contributions and $25 of earnings. A converts the IRA into a Roth IRA in 1998 and elects the 4-year spread. As a result of the conversion, $25 is includible in income ratably over 4 years ($6.25 per year). The 10-percent early withdrawal tax does not apply to the conversion. At the beginning of 1999, the value of the account is $110, and A makes a withdrawal of $10. Under the proposal, the withdrawal would be treated as attributable entirely to amounts that were includible in income due to the conversion. In the year of withdrawal, $16.25 would be includible in income (the $6.25 includible in the year of withdrawal under the 4-year rule, plus $10 ($10 is less than the remaining taxable amount of $12.50 ($25-$12.50)). In the next year, $2.50 would be includible in income under the 4-year rule. No amount would be includible in income in year 4 due to the conversion."

4. Prior law did not contain a specific rule as to what happened if the individual who had made a Roth conversion dies during the four-year spread period (1998 - 2001). The new law states: all remaining amounts shall be included in the gross income of the decedent for the year of death. However, an exception is provided for the surviving spouse. The spouse may elect to continue to use the same spread option which his or her deceased spouse would have used. The election becomes irrevocable after the filing deadline for the year the death occurred.

5. Under prior law, a person received the tax benefit of not having to pay the 10% excise tax for a pre-age 59 1/2 distribution when he or she moved funds from a traditional IRA to a Roth IRA. He or she then could have withdrawn the principal (i.e. the rollover/conversion amount) and not been required to pay the 10% pre-age 59 1/2 excise tax. A person under age 59 1/2 could have effectively taken a distribution from his or her traditional IRA and avoided the 10% excise tax.

The new law imposes the 10% excise tax of Code section 72(t) on any distribution from a Roth IRA arising from a conversion/rollover which occurs before the five-year requirement has been met, to the extent that the distribution is attributable to amounts that were includible in income due to the conversion/rollover and to which the 10% excise tax would have been applied except for the Roth conversion/rollover exception.

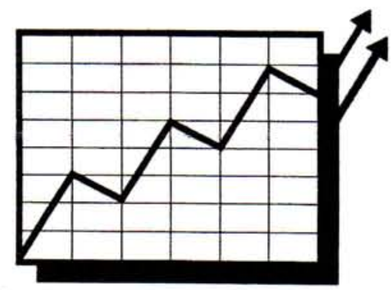
6. The new law creates ordering rules for income taxation purposes with respect to distributions from a Roth IRA. For taxation purposes, a person is considered to have only one Roth IRA even though he or she may actually have many Roth IRAs arising from regular Roth IRA contributions and from conversions in multiple years. The sequence of distributions will be: (a) regular Roth IRA contributions will be distributed first, including any rollover of a Roth IRA containing regular Roth contributions, (b) converted amounts from any traditional IRA will be distributed second (starting with the amounts first converted, and amounts converted which were taxable will be distributed before any nontaxable converted amounts); and (c) earnings on any of the above will be distributed last.

7. There are some people who are over age 70 1/2 who are not eligible to roll over/convert their traditional IRA funds because their required minimum distribution puts them over the $100,000, modified AGI limit. Effective for year 2005 and subsequent years, any required minimum distribution would not count against the $100,000 limit. Note that the required minimum distribution amount is still not eligible to be rolled over.

8. The new law makes clear that a SIMPLE-IRA and a SEP-IRA cannot be designated as a SIMPLE Roth IRA or SEP Roth IRA.

9. The new law creates a simple way for the accountholder to "undo" or correct an unwanted Roth conversion contribution or other contribution. The accountholder now has the authority to transfer funds from one type of IRA (i.e. a Roth IRA) to a traditional IRA and the IRA custodian/trustee of the receiving IRA is required to treat the original contribution as having been made to the recipient IRA. The earnings must also be transferred. The contributor has until his or her tax-filing deadline for such tax year, including extensions, to make the correction.

However, these law changes will cause IRA custodians some administrative headaches. The IRA accountholder will have the right to instruct the IRA custodian that he or she wishes to transfer a previous contribution (and the related earnings) to a different type of IRA. This transfer can either be an internal transfer or an external transfer. For reporting purposes, the entity receiving the transfer is to report as if the original contribution had been made to its IRA. This is a type of retroactive contribution. This is a nice concept for tax purposes, but it will not be the easiest concept to incorporate into an IRA data processing system a—contribution date which is different from the actual contribution date.



Rule Changes Regarding Limits Based Upon Modified Adjusted Gross Income

1. The new law makes it clear that a married person filing a separate return is eligible to make a Roth IRA contribution, but the contribution limit would be modified by using the phaseout range of income of $0-$10,000.

2. The new law makes clear that an individual may contribute up to $2,000 a year to all of his or her traditional and Roth IRAs.

3. The new law makes clear that the $150,000-$160,000 phaseout range applies to a married person filing a joint return if that person is not an active participant, and that the phaseout range of $50,000-$60,000 (for 1998) applies to a married person who is an active participant.

4. The new law does NOT clarify the issue of whether the $100,000 modified AGI eligibility limit for rolling over/converting from a traditional IRA to a Roth means a married person's adjusted gross income, or his or her adjusted gross income as combined with his or her spouse's adjusted gross income. For whatever reason, Congress chose not to clarify this situation.

Other Law Changes Regarding the Traditional IRA

1. The new law states that a person who receives a hardship distribution from a qualified plan is not eligible to roll over this distribution to an IRA. The apparent reason for this change was that someone thought there was a loophole which needed to be plugged. Review the article in the June newsletter concerning this issue. Note that this new restriction applies to distributions occurring after December 31, 1998.

2. The new law states that the 10% excise tax for pre-age 59 1/2 distributions will not apply when the IRS places a levy upon an IRA or pension account of someone who is not yet age 59 1/2. Under prior law, when the IRS took funds or assets via the levy, the individual then had to include this amount in his or her taxable income (i.e. he or she had to pay

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tax on it) plus the individual had to pay the 10% excise tax if he or she was not yet age 59 1/2 and no other exception applied. Under the new law, the person must include the levied amount in his or her income for the year, but he or she will not owe the 10% excise tax. This is a new exception to the assessment of the 10% excise tax. This change applies to levies made after the date of enactment (i.e July 22, 1998) and so is effective now.

Rule Changes Regarding Education IRAs

1. The new law makes clear that the designated beneficiary of an Education IRA must be a life-in-being (i.e. an individual) at the time the Education IRA is established.

2. The new law makes it clear that when there is a change in the designated beneficiary of an Education IRA, the new beneficiary must be younger than age 30.

3. The new law has changed the definition of who is a "member of the family." This is important because the Education IRA can be rolled "tax free" from the designated beneficiary to a member of his or her family.

The prior law defined a "member of the family" as:

> The following individuals (and the spouse of such individuals) are considered to be family members of the beneficiary: (1) a son or daughter or a descendent of either; (2) a stepson or stepdaughter; (3) a brother, sister, stepbrother or stepsister; (4) a father or mother; (5) a stepfather or stepmother; (6) a son or daughter of a brother or sister; (7) a brother or sister of a father or mother; and (8) a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law or sister-in-law.

The change made by the new law is that the spouse of the designated beneficiary now qualifies as a member of the designated beneficiary's family in addition to those listed above.

4. The new law makes clear that there are two (and not just one) times when deemed distributions take place. A deemed distribution has the effect of terminating the Education IRA as there are no longer any funds or assets within the account.

First, there is a deemed distribution 30 days after the designated beneficiary reaches age 30. Second, there is a deemed distribution 30 days after the designated beneficiary dies.

5. A beneficiary can now be named to inherit or assume ownership of an Education IRA after the designated beneficiary dies. Under prior law it was thought that the funds within the Education IRA would have to be paid out to the estate of the deceased designated beneficiary no later than 30 days after the date of death. This is no longer the rule.

The new rules are fairly complicated. If the beneficiary was the spouse of the deceased designated beneficiary, then the spouse becomes the "new" designated beneficiary of the Education IRA. If the beneficiary was not the spouse of the deceased designated beneficiary, then what happens depends upon whether or not this beneficiary was a family member of the designated beneficiary. A new rule states that a family member is to be treated in the same manner as the spouse would have been treated. This means a nonspouse beneficiary who is a family member becomes the "new" designated beneficiary of the Education IRA. However, if the beneficiary is not a family member, then the Education IRA must be distributed to this beneficiary no later than 30 days after the date of death. The rules that apply in this death situation are to be very similar to the rules which apply to Medical Savings Accounts.

6. The law makes clear that the 10% excise tax will not be owed if an excess contribution (plus related earnings) is withdrawn by the due date of the designated beneficiary's tax return (plus extensions). If the beneficiary is not required to file a tax return, then the deadline for withdrawing the excess without adverse income tax consequences is April 15 following the year of contribution.

7. Prior law generally required that a 10% additional tax would be assessed if the distribution from the Education IRA must be included in income. Normally, a distribution from an Education IRA is includible in income because it is not used to pay for qualified higher education expenses within the permissible limits. It is also possible, though, that a distribution which is used to pay for education expenses will be subject to tax (and the 10% additional tax) if the taxpayer elects to claim the HOPE or Lifetime Learning Credit with respect to the beneficiary. The new law adopts the approach that in the HOPE or Lifetime Learning Credit situation, income tax should be owed, but not the 10% additional tax.

8. The new law makes clear that the 6% excise tax which applies to an excess contribution to an Education IRA would apply for each year that an excess remains within the Education IRA and not merely the year the excess is first made.

9. Since 1990, Code section 135 has allowed a taxpayer who pays qualified educational expenses for himself or herself, a spouse, or any dependent, to exclude from his or her gross income any amount redeemed during such year from any qualified U.S. savings bond. The 1997 Act allows a taxpayer who redeems such U.S. savings bonds to contribute these to an Education IRA or to a qualified state tuition program under Code section 529, versus actually paying the educational expenses, and still exclude the income for tax calculations. The new law has been changed so that the definition of "eligible educational institution" as defined in Code section 135 be the same definition as in Code section 529.

Summary. Almost all of the 1998 IRA law changes were really technical corrections and have been known for some time. There were no major surprises. The one change which was really not a technical correction was the new rule that a person, in the year 2005 and later years, can determine whether or not he or she satisfies the $100,000 AGI limit by excluding any required distribution amount to see if he or she is eligible to roll over/convert from a traditional IRA to a Roth IRA.

This article has summarized the new laws or rules. Another article discusses the administrative steps an IRA custodian/trustee or insurance company should now consider because of these law changes. PD

Good News for Insurance Companies—IRS Issues Form 5305-RB

In July, the IRS issued a model Roth Individual Retirement Annuity (Roth IRA) Endorsement form. The IRS has issued Form 5305-RB. This is the first time the IRS has chosen to issue a model annuity endorsement so that insurance companies will have a relatively easy way in which to create a Roth IRA document. For a long time the IRS has had model forms for IRA custodians/trustees.

With the issuance of this model annuity endorsement form, an insurance company will now need to decide whether it should sponsor one or more Roth IRA annuity(ies) or whether it should use the model annuity endorsement. One would think that most insurance companies will elect to use the model annuity endorsement just as most IRA custodians/trustees elect to use the Model Forms, 5305, 5305-A, 5305-R or 5305-RA rather than spending $500 for each submission of an annuity endorsement.

The concept of the model Roth annuity endorsement form is that the insurance company and an individual (i.e. the annuitant) enter into an annuity contract which has been amended by the endorsement to be a Roth IRA.

The IRS announced the issuance of the Roth model annuity endorsement form in Announcement 98-58.

It will be interesting to see if the IRS will also issue model annuity endorsements for traditional IRAs. We will have to wait for further IRS action. PD

Trust Company's Liquidation of IRA—In Compliance With IRS Tax Levy

In a recent court case, *Kane v. Capital Guardian Trust Co., 10th Cir., No. 97-03030, 6/15/98*, an IRA accountholder brought suit against a trust company regarding their response to a tax levy.

Gerald E. Kane had a tax liability of more than $100,000. He also had an IRA that consisted of mutual funds with a value of over $100,000. An IRS tax levy was assessed to recover the tax debt. The levy instructed the Capital Guardian Trust to turn over the "property and rights to property." The trust company complied with the levy by liquidating the IRA mutual fund shares, and remitting the proceeds to the IRS.

The IRS levy meant that Mr. Kane was considered to have withdrawn $100,000 from the IRA. He owed $41,418 to the IRS in income taxes because of this IRA distribution. Presumably, his taxable income was just beyond the 31% marginal tax bracket plus he owed the 10% excise tax because he was not yet age 59 1/2 and no other exception applied.

Understandably, Mr. Kane was not happy. The IRS takes $100,000 from his IRA to satisfy a prior tax debt and now the IRS says he owes an additional $41,418 because the source of the funds was an IRA distribution.

Mr. Kane wanted someone to share his pain. He brought suit against Capital Guardian Trust to recover the additional tax liability through a conversion and breach of fiduciary duty claim. He alleged that they did not surrender his "property" as required by the levy when they liquidated his IRA, because the fundamental character of the property was changed when it was liquidated. He also stated that under U.S.C. Section 6337, the taxpayer had the right to redeem his or her "property" at any time prior to the tax sale.

The court rejected the claim, ruling that the trust company was not at fault for complying with the IRS levy. The IRS had a valid right to step into the shoes of the taxpayer and acquire whatever rights to the property the taxpayer possessed, including his right to liquidate the mutual fund shares in his IRA and withdraw the cash proceeds. The IRS levy granted the IRS his "right to property," and thus, once Capital Guardian converted the IRA to cash in compliance with the levy, Kane no longer had funds to redeem.

In conclusion: A trust company is not liable to an individual retirement accountholder when it responds to a federal tax levy against the account by liquidating the mutual fund shares and remitting the cash proceeds to the government. The court said, "Capital Guardian Trust Company's compliance with the levy acts as a complete defense against Kane's state law claims." Circuit Judges Michael Murphy and Stephen H. Anderson joined Judge Bobby R. Baldock in the court's decision.

A taxpayer will no longer be required to pay the 10% excise tax under Code section 72(t) with respect to a levy imposed after July 22, 1998. PD

Recommended Action—*Continued from page 1*

"inheriting beneficiary" of an Education IRA which can be a person or entity other than the designated beneficiary's estate.

Hopefully, your data processing service provider is working hard to provide you with the software which will allow you to efficiently handle traditional IRAs, Roth IRAs and Education IRAs.

Marketing. You will want to start soon. As with home equity loans, the growth of Roth IRAs and Education IRAs is only a matter of time—once people become convinced or knowledgeable that these accounts have "benefits," they will establish such accounts.

Amendments and Plan Agreements. It is not known at this time if the IRS will revise any of its model forms because of these law changes. We believe that it is most likely that the IRS will not revise any of the model IRA forms. However, amendments are needed to amend or correct the Disclosure Statements.

Existing Accountholders. Amendments should be used for all three types of IRAs and should state the rules which applied prior to the technical corrections act. You should notify your accountholders of the new rules.

Existing Inventory of Unused Plan Agreements. You will also want to provide an amendment when you open any of the IRAs with existing IRA plan agreements. Or, you may wish to consider discarding existing inventory of plan agreements and using newly updated plan agreements.

Other Administrative Forms. Presumably your forms vendor will be recommending to you whether you can continue to use existing inventory, or whether you should use revised forms. You will have to decide after you review the recommendations. One would think you would be able to continue to use most of your existing inventory, but this does depend upon the provisions of the existing forms. PD