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Radical IRA Law Changes Proposed

Congress is presently considering a new tax bill (S. 114 and H.R. 2167) containing a number of IRA law changes. We believe these changes are as radical as the changes President Bush requested be made a number of years ago regarding Retirement Savings Accounts (RSAs), Lifetime Savings Accounts (LSAs), and Employer Retirement Savings Accounts (ERSAs). President Bush's proposed changes were never enacted. Time will tell if these proposed changes will be adopted.

Under current U.S. law, an employer is not required to establish and fund a pension plan for its employees. An employer may sponsor a retirement plan if it chooses to do so. There are many employees who work for employers who do not offer any type of retirement plan. Although IRAs have been in existence since 1975, they are not being used to the degree some policy makers think they should be to increase retirement savings. The concept of the proposed law would to be to require certain employers to set up a payroll deduction program to encourage more people to make IRA contributions and invest such funds "wisely." And, hopefully, employers who would not be required to sponsor such a payroll deduction plan would voluntarily choose to do so as an additional employee benefit.

This proposed law change is radical in the sense that it is the first time that

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Illustration of "Separate Accounting" RMD Calculations

Laura Boyer, age 77, died on 11/4/05. She died after her required beginning date. She had been paid her RMD for 2005 prior to her death. She had designated her four children as her IRA beneficiaries: Anna (12/9/46); Maria (10/9/51); David (12/29/54) and Miguel (10/4/60). Each received a 25% share. The IRA had a FMV balance of $32,400 as of 12/31/05. A separate inherited IRA account was set up for each of the four beneficiaries on March 16, 2006.

What required minimum distributions should have been made for 2005 and 2006 and should be made for 2007?

2006 RMD Calculation

Laura died after her required beginning date. She had been paid the 2005 RMD amount prior to her death. There will need to be four (4) required distributions made to the four beneficiaries in 2006 and subsequent years until the share of each has been completely distributed.

The standard RMD formula is: 12-31-xx FMV balance as divided by a distribution period.

When there are multiple beneficiaries, the general rule is that the oldest beneficiary is used to determine the distribution period. The Single Life Table is used to calculate the distribution period for all inherited IRA situations.

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employers would be mandated to sponsor and maintain a type of retirement plan, albeit one being funded with employee contributions.

The purpose of this article is to discuss the proposed law changes, and then you can decide if these changes would be "good" changes or are needed changes.

The tax bill has been given the title "Automatic IRA Act of 2007." Here is a short summary of the proposed changes:

1. Most employers would be required to establish and administer, for certain employees, a payroll deduction IRA program. That is, an employee would have the right to instruct the employer to withdraw funds from their payrolls and contribute such funds to their IRA or automatic IRA.

2. Certain employers would receive a credit for establishing the payroll deduction program. Large employers would not receive the credit.

3. A new type of IRA would be created. It would be an "Automatic IRA." In most cases, only large financial institutions would be able to offer this "Automatic IRA."

4. A new governmental board would be created to handle the investment and administration of these Automatic IRAs. It would be called the TSP II Board.

The current legal framework for IRAs is as follows. The rules for traditional IRAs are set forth in Code section 408 and Code section 219. The rules for Roth IRAs are set forth in Code section 408A. The rules for SEP-IRAs are the same as those which apply for traditional IRAs plus the special rules found in Code section 408(k). The rules for SIMPLE IRAs are the same as for traditional IRAs plus the special rules set forth in Code section 408(p).

This new program should not be confused with existing payroll IRA deduction programs, the new type of plan would be called, "Payroll Deposit IRA Arrangements."

A new Code section 408(c) would be added to set forth the new rules for Automatic IRAs.

Automatic IRAs

An Automatic IRA would either be a traditional IRA or a Roth IRA which meets certain investment requirements and fee requirements. These requirements would be defined by the TSP II Board after it consulted with the Secretary of the Treasury and the Secretary of Labor. A regulation would be required to be issued within one (1) year of the law's enactment. The regulation must provide that the IRA accountholder has the right to invest in investment options similar to those available to a participant in the Thrift Savings Plan. In addition, the TSP II Board may also provide for additional investment options. The default investment options will need to be defined. The fees to be charged with respect to the offering of the investments, and the providing of administrative services, cannot be unreasonable when viewed in the aggregate. The regulation would be required to define what is "reasonable." Fees are defined to include any and all fees, commissions, asset management fees, compensation for any services, and any other charges or fees related to the IRA plan.

The Secretary of the Treasury and the Secretary of Labor are to jointly conduct a study on whether or not the spousal consent requirements, which apply to the Thrift Savings Plan, should be applied to the Automatic IRAs and whether the law should require or encourage the IRA accountholder to withdraw funds over a long period of time, by using low-cost annuities, longevity insurance, or other guaranteed lifetime income arrangements.

Under current law, terminated participants with a plan balance between $1,000 - $5,000, and who fail to instruct an employer, must have their account balance automatically directly rolled over into an IRA. The law would be changed to allow the rollover into either an IRA or an Automatic IRA. The law would also require that such funds be invested in a default investment as described in Code section 408(b)(5). It appears this change would mean that such funds could not be invested solely in a standard time deposit account or savings account.

Payroll Deposit IRA Arrangement (PDIAs)

Like it or not, every employer with more than 10 employees, with a few exceptions, would be required to sponsor and administer a Payroll Deposit IRA Arrangement (PDIA). The employer would have to withdraw funds from an employee's paycheck at his or

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her instruction and then forward (i.e. pay) such funds to the IRA custodian/trustee of the employee's IRA.

The law does not expressly address whether or not the plan will be an ERISA plan. One would think it would be. Presumably, there will be some reporting requirements.

Under current law, employers have the discretion whether or not they will offer a payroll deduction IRA program. Most employers choose not to. Most do not want the unpaid additional work. Most do not want the additional liability. Under current law, an employee has every right to set up his or her own IRA with the financial institution of his or her choice. Automatic contributions may be made from a person's checking account into their IRA. On the other hand, the savings rate in the U.S. is extremely low, and some policy makers think this program would be a good tool for increasing the savings rate.

Who would be required to sponsor a PDIA?

In general, every employer with more than 10 employees who received at least $5,000 of compensation from the employer for the preceding calendar year. This means an employer with 1-10 employees, who received at least $5,000 of compensation for the preceding year, need not offer a PDIA for the current year. Because of constitutional issues, a governmental entity, or a church, would not be required to offer the PDIA.

There is one exception when an employer with more than 10 employees who received at least $5,000 of compensation for the prior year will not be required to sponsor a PDIA. The exception is for new businesses. An employer is not required to offer a PDIA for a calendar year if the employer was not in existence at all times during the two preceding calendar years. This exception does not apply if the employer has more than 100 employees who received at least $5,000 of compensation from the employer on any day during the two preceding calendar years.

In determining the number of employees, the employer is to use the rules applying to SIMPLE-IRA plans. These rules are found in Code section 408(p)(2)(c). All members of the same family, as defined in Code section 318(a)(1), are treated as one employee, and any reference to the employer also includes any predecessor employer.

Can employers who are not required to establish a PDIA elect to do so?

Yes. One can expect that some small employers would choose to establish a PDIA even though they would not be required to do so.

Failing to Establish the PDIA

If an employer fails to establish and maintain the PDIA, it will be subject to a tax equal to $100 for each employee the law requires to be covered by such plan. This subject is discussed in more detail later.

What requirements must be met to have a PDIA?

The following eight requirements must be met. In many instances, the rules are similar to the rules applying to SIMPLE-IRAs.

1. There must be a written plan agreement setting forth the plan terms. Presumably, the IRS would issue a model form, although the new law does not require the IRS to create this form.

2. The employer must furnish a notice to each eligible employee informing them of his or her right to have money withheld from his or her paycheck so that it can be contributed to the employee's IRA. The notice must set forth the maximum contribution amount for such year and explain that a person's payroll deduction contributions do count against such limit. This notice must be furnished a reasonable amount of time before the election period.

3. The election period for the employees is the 60-day period prior to January 1. During this period, an eligible employee will have the right to elect to participate in the PDIA by instructing how much he or she wishes to contribute on a per payroll basis and how these contributions are to be invested. Also during this period, the individual will have the right to modify previously furnished instructions.

4. A person who has chosen to participate must have the right to terminate his or her participation. He or she must give reasonable notice. The PDIA plan document may be written to provide that such a person is ineligible to resume participation in the plan until January 1 of next year. Alternatively, the plan

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document could limit such ineligibility to one month, three months, six months, etc.

5. An employee has the right to set up his or her IRA with any financial institution he or she wants. However, there is a MAJOR exception. This exception is discussed in more detail later. At this point it is sufficient to understand that the employer may choose a designated financial institution to whom all PDIA contributions would be made. The employer would be required to furnish a notice to all eligible employees informing them of their right to transfer without cost or penalty their account balance to another IRA. With respect to SIMPLE-IRAs the IRS has defined what is meant by "without cost or penalty." Presumably the IRS would adopt a similar approach for PDIAs.

6. The employer must contribute the amounts deducted from the payrolls to the individual's IRA on or before the later of: (i) the due date for depositing the tax related to that payroll, or (ii) the 30th day following the last day of the month with respect to which payments are to be made. For the large majority of employers, this means the deadline for contributing the employee funds will be the last day of the month following the month there was payroll withholding. For example, those amounts withheld in July, would be required to be contributed to the employees' IRAs by August 30.

7. The PDIA must have a calendar year plan year (January 1 to December 31.)

8. If the PDIA does not include an automatic enrollment provision, then the employer must furnish an election form to each eligible employee and obtain his or her express election to either participate or not participate. The PDIA and the election form must provide that the employee's failure to return the forms will mean that he or she has enrolled and has agreed to have 3% withheld and invested in the default investments.

What employees are entitled to participate in the PDIA?

The general rule is that any employee who was not eligible under a qualified plan or arrangement maintained by the employer for service for the preceding calendar year, and for whom it is reasonable to conclude will not be eligible this year, are entitled participate under the PDIA. Eligibility for the prior year is determined as of the last day of the last plan year ending in the preceding calendar year. There are two types of plans which are excluded even if the employee was eligible. First, the plan is excluded if it was frozen as of the first day of the preceding calendar year. Second, the plan is excluded if it is a plan under which only discretionary employer contributions are made, no contributions have been made for the two-year period ending with the last plan year ending in the second preceding calendar year, and it is reasonable to assume the employer will not make a contribution for the plan year ending in the preceding calendar year.

Obviously, any employee of an employer who did not sponsor a plan would meet this requirement and would be eligible under a PDIA.

There are a number of exceptions to the general rule. The employer will be allowed to exclude (i.e. not cover) from the PDIA the following employees:

1. Those employees covered by collectively bargained units and nonresident aliens who received no earned income from sources within the U.S.

2. Those who have not attained age 18 before January 1 of the current year;

3. Those who have not completed at least three months of service with the employer. Under the proposed law it is unclear if these employees would come into the plan as of when they complete the three months of service or as of the following January 1.

4. Those who have not met the one year service requirement, and the age 21 requirement, when the employer maintains a qualified plan which generally has the age and service requirement.

5. Those who are eligible to make salary reduction contributions under a 403(b) plan.

6. All employees of an employer maintaining a SIMPLE-IRA plan.

Can an employer automatically enroll employees in PDIA?

Yes. An employer will be allowed to write the plan document to require an eligible employee to be automatically enrolled unless he or she would inform the employer that he or she did not wish to participate. In

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general, the automatic enrollment rules applying to employer pension plans would apply to the PDIA. The Secretary of the Treasury will have the authority to modify such rules as necessary to carry out the objectives of payroll deduction plans.

As with employer pension plans, there will be times when employees fail to instruct the plan administrator or the employer how he or she wishes to invest their contributions. Such contributions will be required to be "contributed" to a "Secure Retirement Account," or a similar arrangement, as defined in a regulation. Such funds are to be invested in accordance with the rules and regulations under section 404(c)(4).

How do these PDIA contributions coordinate with regular IRA contributions?

These contributions count towards the applicable annual limit. Currently that limit is $4,000 if the person will not attain age 50 this year and $5,000 if the person will attain age 50 or older this year.

All of the existing rules for whether or not the contribution will be tax deductible will continue to apply.

What procedures and rules apply if the employer selects one financial institution to serve as the IRA custodian/trustee for the IRAs of the participants of the PDIA?

It is possible to do this as long as each employee is notified in writing that he or she may transfer their IRA without cost or penalty to another IRA custodian/trustee.

What special payroll tax procedure must be established?

The IRS, after consulting with the TSP II Board, would be required to establish a procedure under which an employer would transmit the IRA contribution along with its payment of taxes (withholding of income taxes, social security and medicare taxes). The employer would transmit information setting forth the name of each employee, his or her TIN, the amount of the contribution, and the investment options applying to the employee. Using this special procedure would be at the employer's discretion.

What is the TSP II Board?

It is a new government board in the executive branch. It is to be similar to the Federal Retirement Thrift Investment Board. The members of the Board are to act solely in the interests of the IRA accountholders and inheriting IRA beneficiaries.

What will be the duties of TSP II Board?

The TSP II Board will be responsible for establishing and maintaining the IRAs of those individuals who have not chosen the IRA custodian or trustee. That is, the TSP II Board has responsibility when the employer has chosen the designated financial institution and the employee has not exercised his or her right to transfer the IRA funds to an IRA which he or she has established with an IRA custodian/trustee. The Board is to establish policies and procedures for investing and managing such IRAs, the policies and procedures for contributing and investing funds when the employer's PDIA provides for automatic contributions, and the establishment of Automatic IRAs. The Board is to adopt a plan of action to expand the use of IRAs by self-employed individuals, members, and employees of voluntary associations.

How will the IRAs set up under the special payroll tax procedure be established and maintained?

TSP II Board would enter into contracts with entities eligible to be an IRA trustee/custodian to establish the IRAs to provide the investment funds, management of the investments funds, record keeping, and other administrative services. The Board is to ensure that the costs for investment and administrative services are to be kept to a minimum.

How will these contributions be invested?

In a life cycle fund similar to what is offered under the Thrift Savings Fund or other investments as specified in regulations written by the TSP II Board. There will need to be asset allocation and extensive diversification.

Will there be a special limitation on rollovers for IRAs established pursuant to the special payroll tax procedure?

Yes. A person would be able to roll over funds from the IRA established pursuant to the special payroll deduction procedure to a regular IRA only if the distribution amount was at least $15,000. Those IRA

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accountholders with less than $15,000 would not be able to move the funds unless the plan document would authorize a transfer. Presumably, the IRA plan document would not do so.

What notice requirements would apply with respect to PDIA?

The employer, of course, would have the duty to furnish a notice to the eligible employees regarding the existence of the PDIA, and their rights under such PDIA, and their rights under such PDIA. The deadlines for furnishing the notice were previously discussed.

The Secretary of the Treasurer will be required to prepare model notices which an employer can use to satisfy the various notice requirements. The main notice is to inform an employee of the existence of this special payroll deduction program and their right to participate in it. However, the Secretary will also need to prepare the notice for those employers who select a designated financial institution informing the employees that they have the right to transfer their funds or contributions to another IRA without the assessment of any fees or charges.

The law stipulates that the IRS is to modify the W-4 form to include the PDIA's notice and election requirements. The IRS would also create forms for enrollment in the PDIA, including automatic enrollment. The IRS is also to create a website for small employers so that they could have access to information and forms.

What role would the Department of Labor (DOL) have with respect to PDIAs?

It would be quite limited. However, since the DOL has "investment" expertise, it would have the duty of developing basic investment guidelines. The guidelines would include:

1. Information on the benefits of diversification;

2. Information on the essential differences, in terms of risk and return, between various investments used for IRAs and pension plans, including stocks, bonds mutual funds, and money market investments.

3. Information on how a person's investment allocations may differ depending on his or her age, years to retirement, and other factors determined by the Secretary of Labor (i.e. DOL);

4. Sources of information where a person may learn more about individual investing, including investment advice and pension rights; and

5. Other investment information related to individual investing as the DOL deems appropriate.

What happens if there would be a "failure" with respect to the PDIA?

The employer would be subject to a tax equal to $100 for each employee who should have had the right to have payroll deductions, but who was unable to realize the tax benefits because of the failure. The tax applies on an annual basis.

The tax is not to be assessed if the employer tried to comply with (i.e. exercised reasonable diligence) and had no knowledge of the reason for the failure. The employer must be able to demonstrate that it has met these two requirements to the satisfaction of the IRS. The IRS will not be able to assess the tax for any failure until 90 days after the employer has responded to a finding by the IRS.

The tax would also not to be assessed if the employer corrects its failure(s) within 30 days. An employer qualifies for this non-assessment treatment only if it has exercised reasonable diligence to comply with the PDIA rules and it provides a complying PDIA within 30 days of when it knew of its failure, or should have known of its failure.

If the employer cannot meet the above requirements, the employer could also petition the IRS to waive the tax. The IRS has the authority to waive the tax where there is a reasonable cause for the failure other than willful neglect and if the assessment would be excessive or inequitable relative to the failure.

Is there a tax credit available for establishing and managing the PDIA?

Yes. For most employers the credit would be limited to $250. The credit is the lesser of: $250 or $25 multiplied by the number of eligible employees for the current year. The credit applies only to an employer maintaining a PDIA for the current year and which, on each day during the preceding calendar year, had no more than 100 employees. The credit applies for the first two years. This credit is unavailable if the employ-

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er claims the small employer startup credit authorized by section 45E for establishing certain retirement plans.

The PDIA credit is available to qualifying employers regardless of whether it is required to establish the PDIA or does so because it thinks it is a good idea.

Conclusion. Congress is now considering legislation to increase the use of payroll deduction IRA programs. Some employers would be required to set up a PDIA. This is a radical change since never before under federal law has an employer been required to maintain a retirement plan for its employees. Those employers who are not required to establish the PDIA could still voluntarily choose to do so. One would expect some will do so as an additional employee benefit. Time will tell whether or not this legislation will be enacted into law and will accomplish the goal of assisting individuals with accumulating the assets needed for their retirement. ◆

Retirement Tips for Individuals

The Service offers an individual the following tips to help him or her take responsibility for their retirement.

Set a Goal — "I think I can save $25 a paycheck." It's easy to procrastinate, so set up a "painless" payroll deduction for saving. It doesn't matter if the money goes into a 401(k) plan, an IRA, or into a plain old-fashioned savings account, just start saving. You can start with a small amount, and increase it whenever your circumstances allow—like when you get a raise, your car payments end, or you get a bonus. Pay yourself now, you'll thank yourself later.

Open an IRA — IRAs are easy to get, easy to contribute to, and easy to save with. Most Americans can set up an IRA—whether it's a traditional IRA or a Roth IRA—and save on taxes. Find out more about IRAs from your bank or financial institution or the resources below.

Learn About Your Employer's Retirement Plan — If you are covered under your employer's retirement plan, your employer is required to give you a plain language explanation of the plan call a "summary plan description." It describes your rights under the retirement plan. To get a summary plan description, ask the plan administrator or your employer.

Review Your Individual Benefit Statement — Your individual benefit statement shows your total plan benefits and the amount that is vested, or fully owned by you. To get an individual benefit statement, ask your plan administrator or employer.

Sign Up for 2007 and 2008 401(k) Contributions — If you are covered under a 401(k) plan, you may have to designate the amount of money you want taken out of your salary and contributed to your 401(k) account.

Take Your Required Minimum Distributions — If you are 70½, you are generally required to receive a required minimum amount from your qualified retirement plan, or IRA, by year-end.

Review Your Social Security Statement — The Social Security Administration likely sends you a Social Security statement each year about three months before your birthday. This statement is your personal record of earnings on which you have paid Social Security taxes and a summary of estimated benefits you and your family may receive as result of those earnings. These benefits include retirement benefits and protection in case you become disabled or die before retirement age. For more information and to request a Social Security statement, go to www.ssa.gov.

Ask the Plan Administrator for the Proper Forms—Learn about Your Spouse's Retirement Plan — Many retirement plans provide benefits for spouses. For example, your spouse's plan may provide that you will receive an annuity unless you consent to distribution in another form. Before signing, read and understand any waiver or consent forms for your spouse's retirement plan distributions. ◆

Qualified Charitable Distributions (QCDs) and RMDs

One of the eligibility requirements to making a QCD, is that a person be age 70½ or older. There is no requirement that a person be alive on his or her required beginning date, or reach his or her required beginning date.

Example. Lillian attained age 70½ on July 2, 2007. Her IRA balance as of December 31, 2006, was $77,600. Her RMD for 2007 is $2,797.40. Her required beginning date is April 1, 2008.

Lillian directs her IRA custodian to make a QCD to her church in the amount of $7,000 on July 20, 2007. By making this QCD, she satisfies her RMD amount of $2,797.40 for 2007. In addition, the entire distribution of $7,000 is tax free. The current tax rules do not allow her to use the amount she withdrew in excess of her RMD ($4,202.60) against her 2008 RMD.

Lillian is able to make a QCD from her IRA to her church once she is age 70½ and then at any time thereafter, assuming she satisfies the other eligibility rules.

If it is now assumed that Lillian would die on December 10, 2007, this would not impact her QCD. Her QCD was finalized in July of 2007. In order to qualify for a QCD, a person, must be age 70½ or older. There is no requirement that a person must reach their required beginning date.

The RMD rules and the QCD rules are separate rules. They certainly are related because a QCD can be used to satisfy a person's RMD, but they are different. In this case, because Lillian died before her required beginning date, there will be no required distribution for 2007. Her 2007 RMD was only "tentative." This does not change the fact that Lillian made a QCD. ◆

Illustrations of Separate Accounting,
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Anna, Maria, David and Miguel will each need to be paid their share of the 2006 required distribution. Anna is the oldest beneficiary. Her age is 60 in 2006. The Single Life Table shows that the distribution period for a person age 60 is 25.2 years. Each has an RMD amount of $321.43 calculated as follows: $32,400 ÷ 25.2 ÷ 4 = $321.43. Note, that all four use the same divisor of 25.2 as based on Anna's age.

Why isn't there a separate calculation made for each beneficiary for 2006?

The reason is: separate accounts are recognized for purposes of calculating RMDs only <u>after the later</u> of: (1) the year the separate accounts are established, or (2) the year of the accountholder's death.

<u>2007 RMD Calculations</u>

Since Laura died in 2005 and the separate accounts were established in 2006, the separate RMD calculations will be permissible for 2007 and subsequent years.

Note that there will be four (4) separate RMD calculations for 2007 and subsequent years. ◆