The Pension Digest

Published Since 1984 Collin W. Fritz & Associates, Inc., *"The Pension Specialists"* August, 1993

1993 Budget Act Contains Limited But Significant Pension Changes

The 1993 Budget Act was one the the more fiercely contested budgets in recent memory. Passage by the Senate required a tie-breaking vote by Vice President Al Gore, and the Act passed by only two votes in the House of Representatives.

Important as they may be (and perhaps unpopular as well), the pension-related provisions of the Act were not the ones that made its passage the "nail-biter" that it became. No changes in IRA plans in general were included. The main effects were felt by qualified plans and Simplified Employee Pensions (SEPs).

Qualified Plan/SEP Provisions

QP, Profit-Sharing and Stock Bonus Compensation Limits Reduced

For purposes of determining pension contributions (and certain other purposes), the maximum employee income that can be taken into consideration is $150,000. (In determining employee compensation, the rules of section 414(q)(6) apply, except that the term "family" will include only the employee's spouse and those children under age 19 at the close of the plan year.)

This $150,000 limit is a reduction from the $200,000 ($238,540 as indexed) allowed prior to this tax bill.

The consequences of reducing the limit from $238,540 to $150,000 may very likely be:

1. Reduce the maximum contribution for any person and the related employer's tax deduction from $30,000 to $22,500.

2. May cause employers to reduce the contributions they make for their employees since the owner may decide it is no longer worthwhile to fund the plan at the previous level it had, because the cost of the contributions for the other employees is too great relative to the individual contribution they receive. (See the example which follows.)

3. The change will make it more difficult for plans to pass the 401(k) non-discrimination test. Under old law, the ADP ratio is 3.81% for someone using the maximum income of $238,540 ($8,994/$238,540). Under the new rules the ratio will be 6% ($8,994/$150,000). This increase in the ADP ratio for a person who is highly compensated will increase the ADP ratio of the class of all

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Court Judgement May Inadvertently Disqualify IRA

... Unfamiliarity With Key Rules May Damage ALL Interests

As has been shown numerous times in the past, IRAs are vulnerable to being reached by someone other than the IRA accountholder for such things as tax levies, creditor claims and, in some states, divorce settlements. Their degree of vulnerability depends somewhat on the jurisdiction because the attitude of the various courts – and even state legislatures – varies tremendously.

Immediate vs. Future Claims

In our experience, most such cases have involved the attachment or transfer of assets for immediate settlement of a claim. For example, pursuant to a divorce decree, a court has clear authority to create a "transfer incident to a divorce." But we are seeing indications that courts are beginning to look at the concept of "collateral": earmarking a funding source in the event that an ongoing or future obligation is not met. Child support and alimony are good examples of such obligations.

IRAs have not gone unnoticed by the courts as such a potential funding source in the absence of, or in addition to, other available resources like real property, savings accounts or securities portfolios.

Transfer or Pledge? For IRAs, a Critical Difference

In addressing a customer bank question, we were recently shown a court

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highly compensated to such an extent that the ADP tests are not satisfied.

Here is an example illustrating why an employer might actually reduce its contribution:

Consolidated Widgets is a one-owner business with a payroll of $400,000 in addition to the owner's $238,540 salary.

Under the prior rules, owner Sarah Sherman contributed 9.43% of her salary of $238,540 (the maximum amount that could be considered under the old $200,000 indexing formula), for a maximum contribution of $22,500 for herself.

Her payroll of $400,000, when multiplied by 9.43% (the same percentage must be applied to all covered under her plan), required another $37,720 in contributions for her employees.

Under the new rules, however, Sarah would have to contribute 15% of her own salary (the maximum percentage amount that was, and remains, allowable) in order to reach the same desired $22,500 contribution for herself.

Now, when her payroll of $400,000 is multiplied by 15%, the contribution she must make on behalf of her employees is $60,000, or $22,000 more than she contributed before.

If Sarah wishes to maintain her current level of total contributions for her $400,000 payroll at $37,720 (9.43%), then her own contribution can only be $14,145 (9.43% multiplied by $150,000 of income – the new maximum that can be considered under the Tax Act of 1993).

In effect, her personal contribution will be $8,355 lower than before if she maintains her current level of employee contributions.

New Indexing Formula More Restrictive, Too

The new $150,000 limit is indexed for inflation, as was the prior maximum of $200,000. But a new indexing limitation in the Tax Act requires adjustments to be in $10,000 increments. If the actual COLA would mean an increase of $7,500, for example, there will be no increase for that year.

A further limiting provision will ROUND-DOWN the adjustment to the next LOWER multiple of $10,000. If the COLA adjustment would mean a $13,000 increase, that increase will be limited to $10,000. This is a departure from the "actual increase" allowance formerly in effect.

The combination of these two new provisions seems punitive in that it will almost certainly result in understating the actual COLA increase.

Based on the current rate of inflation, it would be 1997 before the maximum limit rises from $150,000 to $160,000. Three years' worth of COLA increases will have been lost before the new provisions allow an increase in the $150,000 level.

Effective Date

In general, and for most plans, the above changes generally apply to benefits accruing in plan years beginning after December 31, 1993. In other words, the 1994 plan year.

But there are several deadline exceptions:

1. Collective Bargaining Agreements

For collective bargaining agreements ratified before the enactment of the Tax Act (August 10, 1993), the new rules will not apply to plan years beginning before the earlier of:

a. January 1, 1997, or

b. the later of:

i. January 1, 1994, or

ii. the date on which the last of such collective bargaining agreements terminates, or

iii. under a Railway Labor Act plan, the date that the plan extension or replacement was executed.

2. State and Local Plans

Special transition rules apply to these plans. For further information on such plans, please contact our consulting department at 1-800-346-3961.

Employees' Trust & Annuity Plans, Deferred-Payment Plans

The provision outlined above applying to section 401 qualified pension, profit-sharing and stock bonus plans, in general apply to employer contributions to an employees' trust or annuity plan, and compensation under a deferred-payment plan (section 404 plans).

Simplified Employee Pension (SEP) Plans

Under all SEP plans, except salary reduction SEPs and integrated SEPs, employer contributions must bear a uniform relationship to compensation. In other words, an identical percentage of employees' compensation must be contributed. If it is not, the plan will be considered discriminatory.

As with qualified plans, the upper limit of compensation to which this percentage (15% or $30,000 maximum for SEPs) is applied, has been reduced from $238,540 ($200,000 as indexed for inflation) to $150,000.

This will potentially have a similar effect to that of qualified plans, as described in our earlier example. Unless the maximum contribution percentage is already being utilized, the employer will have to increase the percentage contributed if the higher-paid employees are to receive the same dollar amounts. This, as shown, may have the effect of increasing the dollar outlay in contributions for lower-paid workers.

Cost-of-Living Increase Arrangement Identical to QPs

The same indexing mechanism used for QPs also applies to SEPs. Therefore, no increase in the $150,000 upper limit will take place until such increase(s) total $10,000 or more. And, similarly, they will be rounded to the next-lower $10,000.

Pension Plan 'REIT' Treatment Altered

Another budget provision is aimed at encouraging pension fund investment in real estate investment trusts, known as "REITs". Under the new Budget Act, REIT requirements will be more easily met. A primary benefit of qualifying for a REIT trust is that such a trust is generally not (itself) taxed on income distributed to shareholders.

To provide this desired "encouragement," a pension trust will now typically

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not be treated as a single individual for applying the "five or fewer rule" of Code section 542(a)(2). Previously, a pension trust was treated as a single individual.

The "five or fewer rule" states that if at any point in the last half of the trust's tax year more than 50% of the value of its outstanding stock is owned by five or fewer persons, the trust does not qualify as a REIT.

The "five or fewer" test will now be easier to pass, thanks to what is known as a "look through" provision. Under this provision the beneficiaries of a trust will be looked upon as shareholders in a REIT trust, in proportion to their actuarial interest – their stake – in the trust balance. With these beneficiaries now considered owners, the result will be more owners and greater ease in qualifying for REIT treatment.

Other Important Tax Changes

The tax rates which apply to taxable income have also been increased. This change is retroactive to January 1, 1993, but the taxpayer is given three years to pay the tax increase due to this rate change without interest or penalties.

The highest old-law individual rate was 31%. The highest rate has been increased to 42%, through a phase-out of exemptions and deductions and a surcharge of 10% applied to taxable income in excess of $250,000. The highest bracket without the modification for exemptions, deductions and the surcharge is 36%.

The rate applied to the taxable income of corporations increases from 34% to 35% when taxable income exceeds $10 million.

All income is now subject to tax for medicare purposes. Under previous law, only the first $135,000 was taxed. The tax rate is 1.45% of income for both employer and employee under existing law. The tax rate is 2.9% for someone who is self-employed. These rates do not change. This change is effective January 1, 1994.

Under existing law, some individuals will be required to include more of their Social Security benefits in their gross income than under prior law.

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order that had been issued in January, 1992, attaching IRA assets to ensure that future payments would be made and restricting accountholder access to these funds. Pertinent parts of the court order read as follows:

" ... 5. INVESTMENTS AND PENSIONS – The wife shall retain an interest in the existing Keoghs, IRAs and pension plans for purposes of survivorship and to guarantee the husband's payment of alimony provided herein and after his retirement as a source of funds to make said alimony payments which are itemized as follows: ..."

(there followed a list of various accounts)

" ... In the event the husband defaults on the alimony payments the wife may access said funds for purposes of collecting said alimony."

Rather than being a transfer, this would be, by our understanding of IRS standards, a "pledging" of the IRA. There is a critical difference between the two. Under a transfer incident to divorce, IRA funds are immediately transferred to the possession of a recipient spouse with no tax consequences.

But in this particular case, by restricting the entire IRA plan and reserving its assets for the satisfaction of possible future claims, the court action created a "conditional transfer," with the side-effect of violating the pledging prohibition (Internal Revenue Code section 408(e)(4)) of the IRA agreement. The result? The portion pledged – in this case the entire IRA – would be considered distributed and subject to taxation in that year.

Additional Negative Consequences

In addition, if the accountholder is under 59-1/2, he or she is liable for an additional 10% excise tax for a premature distribution.

Also, and undesirable from the standpoint of the court and the assignee (spouse), the IRA's assets will most likely be diminished by the resulting new tax obligation. This is so because the accountholder normally has the right to specify that funds necessary to cover a tax obligation may be withheld for that purpose.

Must a Pledge be Voluntary?

One might argue that a disqualification and distribution in the case of a pledged IRA should only apply if the pledge was voluntary. In this case it was the court, not the accountholder, which pledged the account. However, our experience with the IRS suggests that the IRS would consider even an involuntary pledge as a a breach of IRA regulations and a loss of tax-deferred status.

In order to preserve maximum assets as collateral, the petitioner would surely prefer that the entire IRA remain intact and be subject to taxation only when – or if – actually distributed. A "private letter ruling" to this effect would have to be sought by the petitioner. But we are doubtful that the IRS would accept this "have-your-cake-and-eat-it-too" approach.

Although the law is unsettled on this, we believe that federal law – through which IRAs were created – would take precedence over a state court action. If so, the taxes now owed, including the 10% premature distribution tax if applicable, would not be available to the petitioner in whose favor the judgement was made.

Further Complications – An Excess Contribution Situation

Since the IRA should have been distributed in 1992 but was not, an excess contribution situation exists with the likely consequence of an additional 6% tax on the IRA account balance until withdrawn.

How Should a Custodian Institution Handle This Situation?

Ideally, a financial institution should be apprised of such a pending court action when there is still an opportunity to educate the attorneys so that they can influence the court's disposition of an IRA or Keogh plan's assets.

Under such circumstances as those described, however, a situation such as this presents some difficult administrative choices for a custodian institution. How should reporting of this or a simi-

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Must IRA Disclosure Contain T-I-S 'APY' Calculations?

One of the requirements of the uth-in-Savings Act is providing the "annual percentage yield" for deposits – the APY – in disclosures, advertising and specifically identified areas of customer/institution communications. This was made a requirement in order to standardize the way in which institutions describe the potential earnings on deposits to make it easier for customers to evaluate and compare investments.

Certainly Truth-in-Savings applies to IRAs, both in deposit disclosure requirements and in advertising for deposits. However, an area in question for us has been whether the IRA disclosure statement – which provides a sample calculation of earnings – is in

essence an "advertisement" of those earnings and therefore subject to the APY requirement. If this were so, this would require an amending of IRA plan disclosure statements.

We contacted the Federal Reserve and asked this question, and received the following response:

While indicating that they would not put the answer "in writing" – a standard government agency practice, we've found – the Federal Reserve representative told us that "Truth-in-Savings and IRA disclosure statements are governed by two separate regulations, independent of one another." Including APY information in an IRA disclosure statement "is not mandatory and should not be a compliance concern."

If you as an IRA custodian have been told, or heard, that APYs in IRA disclosure statements may be mandatory, you can take comfort in the knowledge that this one area of account administration will not be subject to revised procedures because of T-I-S. PD

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larly distributed IRA be handled?

1. If less than 60 days have passed .nce the date of the court order ...

a. Execute a Rollover

If it is within 60 calendar days of the court order that disqualified/distributed the IRA, it may still be possible to execute a rollover transaction to another – or the same – account and save the tax-deferred status of the account balance.

To do this would also require requesting the parties to the legal action and the court that issued the judgement order to change that court order to remove the IRA's status as a pledged asset. When informed of the consequences of letting such an ill-conceived settlement option remain in force, it is likely that the parties to the settlement could negotiate an alternative.

But unless the order is changed to free the IRA funds from their pledged status, a rollover will not resolve the situation.

b. Distribution Reporting Options

How should the distribution be coded? Should it be a 7 or 1 (post-59-1/2 or pre 59-1/2, depending on age) or a code 5 (prohibited transaction)?

We would recommend a code 5 since it was indeed a prohibited pledging transaction that disqualified the IRA.

Gray Area Exists for Prohibited Transaction Effective Date

Technically, a prohibited transaction causes the account to be "deemed distributed" on January 1 of the year the PT occurred. If it is now March 15, then more than 60 days (the normal allowable rollover period) has elapsed since January 1. We are not sure how the IRS would respond to a PT/rollover more than 60 days after January 1 of the current year. But here, at least, a good argument might be made for IRS leniency.

2. If more than 60 days have passed since the date of the court order ...

a. Concede the fact that an unwanted distribution has taken place, and

i. prepare a 1099-R distribution form for the accountholder (withholding the appropriate amount if he or she so wishes);

ii. submit a copy of the 1099-R to the IRS;

iii. Inform the petitioning party(ies) and/or the court of the actions you have taken and why they are necessitated by IRS regulations; or

b. Attempt to get the court order revised and in effect "undo" the damage that has been done to the IRA despite the ineligibility for a proper rollover. We would strongly advise that you consult your institution's legal counsel if you elect this option because this is contrary to a conservative interpretation of the IRA rules.

It will make your accountholder happier than distributing his or her IRA. But there could be undesirable consequences despite your best efforts. It is important that you do not compromise your institution's integrity and/or legal position by appearing to disregard IRS regulations.

Courts Must be Given Direction on IRA Levy Matters

There is a clear need for state courts to be informed of the potential consequences in IRA levy or attachment situations. All concerned, both IRA accountholder and potential assignee(s), will suffer adverse consequences if courts continue to render judgements without a better understanding of IRA law. PD