The tax law changes are, for the most part, beneficial to taxpayers and at the very least increase your flexibility in dealing with retirement plans.

Tax Law Changes and How They May Affect Your Retirement Plans

By Clark M. Blackman II and Kevin P. McAuliffe

The more things change, the more they stay the same!

Three provisions of the Small Business Job Protection Bill of 1996 (the minimum wage bill, signed by President Clinton on August 20), take us back to pre-1986 days: Five-year averaging is repealed, the required beginning date for distributions is reinstated to the later of retirement or age 70½, and the excess distributions tax penalty will be suspended for the next three years.

In addition, the Health Insurance Portability and Accountability Bill (signed August 21) provides IRAs with flexibility for certain withdrawals that are already permitted for employer plans.

This article explores the various changes to both employer-sponsored and individual retirement plans that will be brought about by these new laws, and it provides some guidance on how your retirement planning will be affected as a result.

What Has Changed: A Summary

Here's a brief listing of the new provisions:

The Small Business Job Protection Act of 1996:

- Five-year averaging is repealed beginning January 1, 2000.
- A simplified method for calculating the taxable portion of qualified pension payments is introduced.
- The required beginning date for employer-sponsored retirement plan distributions may be deferred until retirement date if later than the year you reach age 70½.
- For employers with 100 or fewer employees, a Savings Incentive Match Plan for Employees (SIMPLE) may be used in place of more complicated pension and profit-sharing plans.
- Tax-exempt organizations other than state and local government entities may now provide 401(k) plans for employees.
- Non-working spouses are now eligible for a full $2,000 IRA contribution beginning in 1997.
- The excess distributions tax will not be levied on distributions from qualified plans after December 31, 1996, and before January 1, 2000.
- No reduction in grandfathered qualified plan balances will result from distributions occurring after December 31, 1996, and before January 1, 2000.

The Health Insurance Portability and Accountability Bill:

- Withdrawals from IRAs for medical expenses will be given the same penalty-free status as already allowed for employer plan distributions.

What do these changes mean to you and your financial planning? Here's an item-by-item description.

Repeal of Five-Year Averaging

Five-year averaging is an income tax calculation available for qualifying lump-sum distributions from employer-sponsored retirement plans; it is not available for IRA distributions. For individuals who meet all the various qualifications and who wish to distribute all their company plan assets during the year of retirement, five-year averaging may allow for more favorable tax treatment.

Beginning January 1, 2000, five-year averaging treatment will no longer be permitted. One requirement in qualifying for averaging is that the recipient must be age 59½ upon distribution of the proceeds. Therefore, taxpayers born after June 30, 1940, will never be allowed to elect this special tax treatment. Those who do qualify must elect the provision for distributions prior to the year 2000.

Five-year averaging (and 10-year averaging allowable for individuals born prior to January 1, 1936) is one of the few remaining tax differences between IRA and company-sponsored plan distributions. Averaging is of greatest benefit to retirees with small employer-

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sponsored plan balances (say, less than $70,000). This is particularly true when the retiree has few other financial resources available and needs to begin spending qualified plan assets right away.

For most retirees who have access to pension annuities, Social Security and personal investment assets, this rule change is not likely to have a significant impact. For many, the benefit of allowing the assets to continue to grow within the shelter of the company plan or rollover IRA outweighs the benefits of five- and 10-year averaging.

Ten-year averaging will continue to be available for individuals born prior to January 1, 1936. This tax calculation typically gives better results than five-year averaging until the plan balance is between $400,000 and $500,000. However, it is not necessarily the best planning strategy to take your distribution sooner than needed, just to qualify for the averaging benefit. As mentioned above, the lost benefit of tax deferral during the ensuing years of retirement can be too high a price to pay in many circumstances.

Present law allows the beneficiary or estate of a decedent to exclude up to $5,000 in death benefits paid by an employer. The new bill repeals this provision effective with the date of enactment.

Qualified Plan Annuities

Recovery of aftertax dollars from employer-sponsored plans has been simplified. Until now, an individual would exclude from income those amounts that had already been taxed (your cost basis) by calculating the ratio of aftertax contributions to total expected benefits (this amount being actuarially computed in the first year of distribution). For example, if it was determined based on IRS tables that the total value of your pension was $200,000, and you contributed $40,000 after tax, then your exclusion ratio would be 20%. Each month you received a payment, you would exclude 20% until your cost basis was fully recovered. If you died before your basis was recovered, a deduction was allowed on your final income tax return.

Under the new law, the amount to be excluded is based on the following table:

Age	No. of Payments
Under 56	360
56 to 60	310
61 to 65	260
66 to 70	210
Over 70	160

To determine the amount of aftertax contributions you may exclude each month, divide the total cost basis by the appropriate number of payments from the table. For example, Joe is age 62 and has contributed $40,000 toward his pension plan on an aftertax basis (in other words, he has *already* paid income taxes on these contributions.) Each month, he can exclude $153.85 ($40,000 ÷ 260) from taxable income, until he recovered his $40,000 (in 260 months). Based on the statutory language, it appears that the deduction for unrecovered basis will continue. This new rule applies to annuities that commence 90 days after the enactment date.

Postponing Distributions

Beginning in January of 1997, employees will no longer have to take distributions from their employer plans, even though they have passed the age where such distributions are generally required. The normal required beginning date is, typically, the year an individual turns age 70½, regardless of employment status. You have until April 1 of the year following the year you turn 70½ to make the distribution; annual distributions must then be made by December 31 of each year.

The new rules will allow an employee who continues to work (and does not own 5% or more of the employer) to continue to defer distributions from their employer plans. If you are already over 70½, still employed, and taking distributions from an employer plan, the plan could permit you to stop taking these distributions until you retire, but it is not *required* to allow this.

If you decide to postpone pension annuity payments, your employer will be required to actuarially increase the future monthly benefit. This was not the case in the past. However, you may wish to begin receiving payments as soon as possible, even though you continue to work—sometimes a bird in the hand is better . . ..

SIMPLE: A New Type of Plan

If you are a small business owner, or an employee of a small business, you will likely be interested in a new way for businesses with 100 or fewer employees to provide retirement benefits. We will only touch on the main points of this new provision.

Beginning January 1, 1997, a SIMPLE retirement plan will allow employees to contribute a percentage of salary to an IRA or 401(k) plan, up to $6,000 per year (indexed for inflation). The plan must be employer-sponsored and the employer must make matching contributions under one of the following two formulas:

- The employer can match, dollar for dollar, contributions up to 3% of a participating employee's compensation, or
- The employer can contribute 2% of every eligible employee's compensation to an account for each employee's benefit, regardless of participation.

Distributions from SIMPLE accounts will be treated the same as distributions under an IRA. However, early withdrawals during the two-year period beginning on the date of initial participation will be subject to a 25% early withdrawal penalty instead of the 10% penalty that applies to most types of tax-deferred retirement plans. [For more on the 10% early withdrawal penalty and ways to avoid it, see "Distributions Before 59½: How to Avoid the Penalty for Early Withdrawals," by Clark Blackman II and Kathleen Canty, in the August 1995 *AAII Journal*.]

401(k)s for Tax-Exempt Groups

Under present law, tax-exempt organizations and state and local governments are generally prohibited from establishing 401(k) plans. However, effective January 1, 1997, charities, churches, and other tax-exempt organizations (but not state and local governments) can establish 401(k) plans.

Spousal IRAs

Through the end of 1996, a one-income household may contribute a *combined* maximum of $2,250 to IRAs established for each spouse (no more than $2,000 is allowed to be contributed to any given account, with the remainder going to the other account—for instance, a 50/50 split is allowed such that $1,125 goes to each or $2,000 could go in one account while $250 is put in the other).

Beginning in 1997, as much as $2,000 may be contributed to each spouse's account, for a total contribution of $4,000. The only limitation is that the combined compensation of both spouses must be at least equal to the contributed amount.

Note that we are talking about overall contribution limits, not *deductible* contribution limits. The rules governing deductible IRA contributions are the same as under prior law. Therefore, although you may contribute up to $4,000 to IRAs per year beginning in 1997, the amount you can *deduct* will depend on your adjusted gross income and your (or your spouse's) status as a participant in an employer-sponsored plan.

Waiver of Excess Distributions Tax

Under current rules relating to distributions of qualified plan assets, an excise tax of 15% is levied on distributions that are in excess of the threshold amount of $155,000 (this year's threshold as indexed for inflation). [For more on excess distributions and accumulations, see "Understanding the 15% Excess Distributions and Accumulations Penalties," by Clark Blackman II and Kevin McAuliffe, in the June 1995 *AAII Journal*.)

For distributions received during 1997, 1998, and 1999, the 15% excess distributions tax will be waived. The reason given for providing this relief window is to offset the revenue effect of several new provisions, such as the spousal IRA increase and the repeal of the combined plan limit, which can reduce qualified plan assets for those who participate in more than one retirement plan. The thinking in Congress is that suspension of the 15% tax will encourage people to withdraw plan assets and pay taxes sooner, resulting in a short-term revenue increase.

Regardless of Congress' rationale, this will provide a break for all those retirees who find themselves in the enviable position of having to distribute more than the threshold amount from the plans. However, we want to advise caution during this window period. It may not be in your best interest to accelerate distributions and pay taxes early, simply to avoid the excise tax in the future.

As we demonstrated in an earlier column ["Avoiding the Penalty for Excess Distributions and Accumulations—Revisited," in the October 1995 *AAII Journal*], using reasonable assumptions for growth and tax rates, the net savings of accelerating distributions may be minimal. To incur an immediate and certain cost (the loss of tax-deferred growth) for a less certain future potential benefit (avoidance of higher taxes) may not be advisable if the calculated net benefit is small.

Note that the excess accumulations tax will continue to apply at death during this period.

Grandfathered Amounts

If you were fortunate enough to have a qualified plan balance in excess of $562,500 on August 1, 1986, you may have filed a "grandfather" election to protect the existing balances from the 15% excise tax for excess distributions and accumulations.

As you begin taking distributions, this grandfathered amount is used up, a portion each year. During the period from January 1, 1997, through December 31, 1999, no amount of your grandfathered balance will be deemed used. Therefore, not only can the excess distributions tax be avoided, but all of your grandfathered plan assets can be saved for distribution at a later date, when they may be of some use in sheltering you from this penalty tax.

Withdrawals for Medical Expenses

As we have mentioned in prior columns [the August 1995 column on early withdrawals, cited earlier], distributions from employer-sponsored plans could avoid the 10% penalty for early distributions if used for qualified medical expenses. Essentially, these are medical expenses in excess of 7.5% of adjusted gross income, which may be itemized as deductions on your IRS Form 1040, Schedule A.

Beginning with the 1997 tax year, this same exclusion from penalty will apply to distributions from IRAs. In addition, if you are collecting unemployment insurance for at least 12 weeks during the year such distributions are made, you may also avoid the penalty for distributions used to pay medical *insurance* costs without regard to the 7.5% adjusted gross income test.

Conclusion

Numerous changes in the tax law affecting your retirement plans and planning deserve your attention. In all cases except the repeal of five-year averaging, the change may be beneficial to the taxpayer. Even the repeal of five-year averaging could be seen as a blessing in disguise, since it may have encouraged individuals to take earlier withdrawals than they should have, losing the benefit of long-term deferral of taxes.

We will keep watch for other changes and modifications to the tax laws as they occur and will pass these along. You can anticipate potentially significant changes to these rules over the next several years, and we will strive to keep you informed along the way.