Pension ANALYST

Important Information | New Legislation | August 1998*

PRUDENTIAL RETIREMENT

The IRS Restructuring and Reform Act Contains Provisions Affecting Qualified Plans and IRAs

WHO'S AFFECTED This new law affects sponsors of qualified defined benefit and defined contribution plans, including governmental plans and nonelecting church plans, as well as sponsors of tax-sheltered annuity programs and holders of individual retirement accounts and annuities (IRAs).

BACKGROUND AND SUMMARY On July 22, 1998, President Clinton signed into law the Internal Revenue Service Restructuring and Reform Act of 1998. In addition to creating a "kinder and gentler" IRS, this law contains provisions that have varied affects on qualified plans, tax-sheltered annuity programs and IRAs. These provisions include:

- A change in the definition of "eligible rollover distribution" to exclude hardship withdrawals of 401(k) and tax-sheltered annuity salary deferral contributions.
- Elimination of the early withdrawal 10% penalty tax with respect to qualified plan and IRA withdrawals made to comply with IRS tax levies.
- Technical corrections to the SIMPLE IRA rules.
- Closing loopholes in the Roth IRA rules.

ACTION AND NEXT STEPS The revised definition of "eligible rollover distribution" is effective for distributions made on or after January 1, 1999. The elimination of the 10% penalty tax on early withdrawals made to comply with IRS tax levies applies to distributions made on or after January 1, 2000. SIMPLE IRA technical corrections are effective retroactively to 1997, while the Roth IRA revisions are generally effective for 1998.

*Republished December 2004 to reflect Prudential Financial's acquisition of CIGNA's retirement business.

Prudential Financial

IN THIS ISSUE

The Internal Revenue Service Restructuring and Reform Act of 1998 (IRRA), which President Clinton signed into law July 22, 1998, has little direct impact on employer-sponsored retirement programs. While IRRA does eliminate the Office of Employee Plans and Exempt Organizations (EP/EO), Congress intended for the IRS to continue to perform EP/EO functions (such as the voluntary plan correction programs), with adequate funding.

Aside from the actual IRS reorganization provisions, IRRA does contain various "technical corrections" that affect retirement programs.

Hardship Withdrawals Are Not Eligible for Rollover

Congress became concerned that individuals were taking hardship withdrawals from their 401(k) plans and tax-sheltered annuity programs, directly rolling over these amounts to IRAs, and then withdrawing these amounts penalty-free under the first-time home buyer exception (or the educational expense exception) to the 10% early distribution penalty tax. To stem this tide, IRRA provides that hardship withdrawals of 401(k) and tax sheltered annuity deferral contributions are no longer considered "eligible rollover distributions."

Therefore, these withdrawals cannot be rolled over to other qualified plans, tax-sheltered annuities, or IRAs, either directly or indirectly. In addition, they will not be subject to mandatory 20% federal income tax withholding. Instead, 10% withholding will apply, and individuals may elect to have no federal taxes withheld at all.

There are two other important consequences of this reclassification of these hardship withdrawals.

- If an employee takes a hardship withdrawal of his 401(k) or tax-sheltered annuity deferral contributions to purchase a home and that purchase falls through, he will no longer be able to rollover the distribution, either back to the plan from which it came or to an IRA. Unless he can increase his contributions to offset the amount of the distribution, the employee will be subject to current taxation on the distribution, and will lose the benefit of tax-deferred compounding of investment earnings.
- Only hardship withdrawals of deferral contributions are no longer eligible rollover distributions. If a plan allows hardship withdrawals from employer contributions, those withdrawals are still considered eligible rollover distributions, subject to mandatory 20% withholding if they are not directly rolled over to another plan or IRA. An employee who takes a hardship distribution of all available funds will now be faced with a dizzying set of tax rules.

These rules are effective for distributions made on or after January 1, 1999.

Early Withdrawal Penalty Does Not Apply to IRS Levy Distributions

When an individual owes back taxes to the IRS, the IRS may levy on the individual's qualified plan, tax-sheltered annuity or IRA accounts. In general, the plan may turn over these funds to the IRS if the participant currently has the right to withdraw these amounts. However, the amounts paid out to the IRS are treated as a taxable distribution to the participant, subject to 20% federal income tax withholding as well as the 10% early distribution penalty tax if the individual has not reached age 59½.

Under IRRA, the 10% early distribution penalty tax will not apply to distributions made on or after January 1, 2000, in response to an IRS tax levy.

SIMPLE IRA Merger Grace Period

To sponsor a SIMPLE IRA, an employer must:

- Have no more than 100 employees who received at least $5,000 compensation from the employer in the preceding calendar year;
- Not currently maintain any other qualified plan; and
- Permit all employees who received at least $5,000 compensation from the employer during any two consecutive calendar years and are reasonably expected to receive at least $5,000 compensation during the current year to participate in the plan.

IRRA clarifies that if an employer fails to meet any of these requirements as the result of an acquisition, merger or similar transaction, it can continue to sponsor an existing SIMPLE IRA during a grace period. This grace period begins on the date of the transaction and ends on the last day of the calendar year following the calendar year in which the transaction occurs. However, this grace period is only available if the plan's coverage does not change significantly during this period and the employer would have met the three sponsorship requirements if the transaction had not occurred. Note that a SIMPLE IRA that has been in existence for less than one year before a transaction date is eligible for this grace period.

Distribution of SIMPLE IRA Excess Contributions

The IRRA technical corrections make it clear that SIMPLE IRA deferral contributions exceeding the annual limit ($6,000 for 1998) may be withdrawn without penalty from the employee's account before his tax filing deadline, including extensions, for the year in which they were made. However, earnings on these excess contributions must also be withdrawn and are subject to the 10% early distribution penalty tax. Nondeductible deferral contributions that are not withdrawn before the employee's tax filing due date are subject to a 6% excise tax until they are withdrawn. This provision applies to tax years beginning on or after January 1, 1997.

Roth IRA Rules Are Clarified

Last year, the Taxpayer Relief Act of 1997 (TRA'97) created the Roth IRA. IRRA technical corrections now clarify a number of the Roth IRA rules, effective for tax years beginning January 1, 1998.

- IRRA has closed the loophole that appeared to let individuals convert a traditional IRA to a Roth IRA and then immediately withdraw the converted amounts while avoiding the 10% early distribution penalty that would have applied if the amounts had been distributed directly from the traditional IRA. Now, amounts converted from a traditional IRA to a Roth IRA must remain in the Roth IRA for at least five years to avoid the early distribution penalty tax.

- A SEP or SIMPLE IRA cannot be a Roth IRA.

- Contributions made to a SEP or SIMPLE IRA are not taken into account when determining the maximum amount that an individual can contribute to a Roth IRA for a tax year.

- Contributions made to one type of IRA (traditional or Roth) may be switched to the other type of IRA, if a trustee-to-trustee transfer is made before the individual's extended tax filing deadline for the year the contributions are made. This provision allows an individual who made an improper conversion to a Roth IRA to reverse that conversion. It also lets an individual who made an improper contribution to a Roth IRA (for example, because his income exceeded the applicable limit) convert it to a traditional (nondeductible) IRA contribution.

In addition, we understand that the IRS is expected to publish its Roth IRA regulations before the end of the Summer.

Pension Analyst by Prudential Retirement
The Pension Analyst is published by Prudential Retirement, a Prudential Financial business, to provide clients with up-to-date information on current legislation and regulatory developments affecting qualified retirement plans.

Editor: Mitzi Romano (860) 534-2768