

MEMO# 22192

February 7, 2008

President's Budget Contains Tax, Savings and Pension Initiatives

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TO: 529 PLAN MEMBERS No. 2-08
BANK, TRUST AND RECORDKEEPER ADVISORY COMMITTEE No. 5-08
BROKER/DEALER ADVISORY COMMITTEE No. 6-08
FEDERAL LEGISLATION MEMBERS No. 2-08
OPERATIONS MEMBERS No. 1-08
PENSION MEMBERS No. 5-08
SMALL FUNDS MEMBERS No. 7-08
TAX MEMBERS No. 2-08
TRANSFER AGENT ADVISORY COMMITTEE No. 6-08 RE: PRESIDENT'S BUDGET CONTAINS
TAX, SAVINGS AND PENSION INITIATIVES

The President's fiscal year 2009 budget contains proposals requiring basis reporting on security sales and conformity of penalty standards applicable to tax return preparers and taxpayers. [\[1\]](#) It also includes a number of other important tax, savings and pension proposals, many of which were included in the President's fiscal year 2008 budget. [\[2\]](#)

Basis Reporting

As proposed in last year's budget, the President's 2009 budget proposes to require that certain brokers (including mutual funds) report information regarding adjusted basis on the sale of certain publicly traded securities. The proposal also would require brokers to report acquisition or disposition dates for securities to allow taxpayers and the Internal Revenue Service (the "IRS") to determine short-term or long-term gain or loss. If a customer transfers securities from an account with one broker to an account with another, the transferor broker would be required to provide the relevant information to the transferee.

Information about basis adjustments that are applicable to all holders of securities of a particular class would be available to brokers either directly from the relevant issuer or indirectly from the issuer through a central repository of information.

The IRS and the Treasury Department would have regulatory authority to promulgate specific rules, including exceptions, to implement this proposal. For example, regulations would exempt a broker from reporting items of information that the broker is unable to obtain with reasonable efforts. Further, the President's budget suggests that regulations may establish a regime through which customers provide information to their brokers about customer transactions that produce adjustments to basis and about the customers' initial basis in securities when the broker has no other way of knowing this information.

The basis reporting provisions would apply to securities acquired after December 31, 2009. The proposal is estimated to generate \$7.48 billion over ten years.

Penalty Standards Applicable to Tax Return Preparers

The Budget proposes to conform the tax return penalty standards applicable to preparers and taxpayers; both would need substantial authority for undisclosed positions. This proposal would amend recently enacted legislation that requires tax preparers to have a reasonable belief that an undisclosed position would more likely than not be sustained on the merits. Taxpayers currently must meet the lower substantial authority standard for undisclosed positions. The Budget also proposes to apply the substantial authority standard to preparers for positions related to tax shelters. However, the "more likely than not" standard still would apply to preparers for positions related to transactions determined to have a potential for tax avoidance or evasion under section 6662A.

The proposal would be effective for tax returns prepared after January 1, 2008.

Information Reporting on Payments to Corporations

As proposed in last year's budget, the 2009 budget proposes a requirement that businesses file an information return with the IRS for payments aggregating \$600 or more in a calendar year to a single corporation (other than a tax-exempt corporation). Current regulations provide certain information reporting exceptions for payments to corporations. The President believes that those exceptions should be eliminated because the number and complexity of corporate taxpayers have increased.

The proposal would be effective for payments made to corporations on or after January 1, 2009. It is estimated to raise \$8.225 billion over ten years.

Information Return Penalties

The Budget proposes to increase each of three tiers of penalties for failure to file timely an accurate information return. For correct information returns filed after the prescribed filing date, but on or before the date that is thirty days after the prescribed filing date, the proposal would increase the penalty from \$15 to \$30 per return ("first-tier penalty"). The calendar year maximum for the first-tier penalty would increase from \$75,000 to \$250,000 (from \$25,000 to \$75,000 for small filers with average annual gross receipts not exceeding \$5,000,000). For correct information returns filed more than thirty days after the prescribed filing date but on or before August 1, the proposal would increase the penalty from \$30 to \$60 per return ("second-tier penalty"). The calendar year maximum for the second-tier penalty would increase from \$150,000 to \$500,000 (from \$50,000 to \$200,000 for small filers).

For correct information returns filed after August 1, the proposal would increase the penalty from \$50 to \$100 per return ("third-tier penalty"). The calendar year maximum for the third-tier penalty would increase from \$250,000 to \$1,500,000 (from \$100,000 to \$500,000 for small filers). For a failure to file due to intentional disregard of a filing requirement, the minimum penalty for each failure would increase from \$100 to \$250 with no calendar year limit. Last year's budget included the same proposals for increasing the third-tier penalty and the penalty for a failure to file due to an intentional disregard of a filing requirement.

This proposal is expected to raise \$391 million over ten years. It would be effective for information returns required to be filed on or after January 1, 2009.

JGTRRA Permanence

As proposed in last year's budget, the President's 2009 budget proposes to make permanent the reduced tax rates on qualifying dividends and capital gains enacted by the Jobs and Growth Tax Relief Reconciliation Act of 2003 ("JGTRRA"). These provisions, which were extended by the Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA"), are scheduled to expire after 2010.

EGTRRA Permanence

As proposed in last year's budget, the 2009 budget proposes to make permanent all of the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") that are scheduled to expire after 2010, including the reduced individual tax brackets and rates. [\[3\]](#)

Expansion of Qualified Mortgage Bonds to Refinance Subprime Mortgages

The Budget proposes to amend the program requirements for tax-exempt qualified mortgage bonds to permit state and local governments to use these bonds to refinance existing loans of eligible subprime mortgage holders. Currently, qualified mortgage bonds finance new mortgage loans to eligible first-time homebuyers of owner-occupied single-family housing.

The proposal would increase the annual private activity bond volume cap applicable to qualified mortgage bonds by \$15 billion; the additional funds would be used exclusively to refinance subprime mortgages and allocated among the states in proportion to population. The proposal targets a class of subprime borrowers with a reasonable foreseeable risk of default and a reasonable potential to avoid default with a lower cost refinancing. The proposal would give state and local authorities discretion and flexibility to tailor the program to local needs.

The proposal would grant temporary authority to refinance subprime mortgages from 2008 through 2010.

Extension of Federal Statute of Limitations for Certain State Tax Adjustments

The Budget proposes to extend the general three-year federal statute of limitations for assessments of federal tax liability resulting from adjustments to a state or local tax liability. The proposal would extend the three-year limitations period the greater of (1) one year from the date the taxpayer files an amended tax return with the IRS reflecting adjustments to a state or local tax return, or (2) two years from the date the IRS receives information from a state or local revenue agency under an information sharing agreement. The proposal would extend the limitations period only for increases in federal tax attributable to a state or local tax adjustment. The proposal also would extend the limitations period on refund claims so that tax increases assessed by the IRS as a result of a state or local examination report would include agreed upon tax decreases attributable to a refund or credit.

The proposal is expected to raise \$47 million over ten years. It would be effective for returns required to be filed after December 31, 2008.

Consolidation of Savings Vehicles

The Budget reintroduces Retirement Savings Accounts (“RSAs”), Lifetime Savings Accounts (“LSAs”), and Employer Retirement Savings Accounts (“ERSAs”). These proposals are largely the same as proposals included in the President’s budgets for fiscal years 2005, 2006, 2007, and 2008. [\[4\]](#) The Budget does not, however, include a proposal for Individual Development Accounts (“IDAs”), which was included in prior years (but excluded from the

FY 2008 budget).

A. RSAs

The President's RSA proposal is the same as last year's proposal. Under the proposal, individuals may contribute up to \$5,000 per year (indexed for inflation). There would be no age or income limitations, except that contributions cannot exceed compensation. Like Roth IRAs, contributions to RSAs would be nondeductible, account earnings would accumulate tax-free and qualified distributions would be excluded from gross income. The President's proposals regarding RSAs would become effective beginning on January 1, 2009.

Qualified distributions from RSAs could be made after age 58 or in the event of death or disability. Nonqualified distributions in excess of prior contributions would be included in income and subject to additional tax. Married individuals could roll amounts from their RSAs to their spouse's RSAs, and the Saver's Credit would apply to RSA contributions.

The President's proposal would rename Roth IRAs to RSAs and subject them to the new RSA rules. Existing traditional and nondeductible IRAs could be converted to RSAs in a manner similar to current Roth IRA conversions - by taking the conversion amount into gross income. Conversions would not be subject to income limitations and would not be mandatory. Taxpayers who convert their IRAs to RSAs prior to January 1, 2010 could include the conversion amount in income ratably over four years. Conversions made on or after January 1, 2010 would be included in income in the year of conversion.

New traditional IRAs also could be created to accept rollover contributions from employer plans, but these accounts could not accept any new contributions. Additionally, individuals could roll over amounts from an employer plan directly into an RSA by first taking the rollover amount into income. Amounts converted to an RSA from a traditional IRA or from an ERISA would be subject to a five-year holding period starting with the year of the conversion. Distributions attributable to either a traditional IRA or ERISA and made prior to the end of the five-year holding period would be subject to an additional 10 percent early distribution tax on the entire amount of the distribution.

B. LSAs

The President's 2009 budget reintroduces the Lifetime Savings Account ("LSA"), which was introduced in the budget for FY 2004 and included in the budgets for FY 2005, FY 2006, FY 2007, and FY 2008. This year's LSA proposal is the same as in the FY 2008 budget proposal. The President's proposals regarding LSAs would become effective beginning on January 1, 2009.

The LSA proposal permits conversion of balances in Coverdell Education Savings Accounts (“ESAs”) or section 529 qualified tuition plans (“529 plans”) into LSAs. All conversions must be made before January 1, 2010, subject to certain limitations. Amounts could be rolled over into an individual’s LSA only if that individual was the beneficiary of the 529 plan as of December 31, 2007. The amount that may be rolled over to an LSA from a 529 plan is limited to the sum of (1) the lesser of \$50,000 or the amount in the 529 plan as of December 31, 2007 and (2) any contributions and earnings to the 529 plan made in 2008. Total rollovers to an individual’s LSA attributable to 2008 ESA and 529 plan contributions, however, cannot exceed \$2,000 plus earnings on those contributions.

Individuals could also choose to continue to contribute to ESAs and 529 plans as under current law, and these education accounts could be offered inside an LSA. For example, states could offer LSAs with the same investment options available under the state’s 529 plan. Such an LSA would not be subject to the 529 plan’s reporting requirements, but investors would be subject to the annual LSA contribution limit. Distributions for purposes other than education would not be subject to federal income tax or penalties. States could, however, offer state tax and other incentives for using such LSA funds exclusively for education.

C. ERSAs

The President’s ERSA proposal would consolidate 401(k) plans, SIMPLE 401(k) plans, after-tax plans, 403(b) plans, governmental 457 plans, SARSEPs and SIMPLE IRAs into one retirement plan. The ERSA would be available to all employers and would be subject to simplified administrative rules that generally follow the rules applicable to 401(k) plans. Employees could defer wages of up to \$15,500 annually (indexed for inflation), with employees aged 50 and older able to defer an additional \$5,000 per year (indexed for inflation).

The maximum total contribution (including employer contributions) to ERSAs would be the lesser of 100 percent of compensation or \$46,000. ERSA contributions could include pre-tax deferrals, after-tax employee contributions or Roth-type contributions, depending on the design of the plan. Distributions of Roth-type and non-Roth after-tax employee contributions would be excluded from income. All other distributions would be included in income.

ERSAs would be subject to simplified discrimination testing. Existing 401(k) and after-tax plans would be renamed ERSAs and could continue to operate as under current law, subject to the simplified ERSA rules. Existing SIMPLE 401(k) plans, SIMPLE IRAs, SARSEPs, 403(b) plans and governmental 457 plans could be renamed ERSAs and become subject to the ERSA rules; or these plans could continue to exist separately but could not accept new contributions after December 31, 2009. Special transition rules would apply to collectively bargained plans and plans sponsored by state and local governments. This proposal would become effective for years beginning after December 31, 2008.

Saver's Credit for Contributions to 529 Plans

The 2009 Budget would allow eligible taxpayers to take the Saver's Credit for contributions to 529 plans. Under current law, taxpayers may receive the nonrefundable credit on up to \$2,000 contributed to elective deferral plans or IRAs. Contributions to a 529 plan are not deductible from income for Federal tax purposes, although earnings on contributions accumulate tax-free within the plan. Allowing the Saver's Credit for contributions to a 529 plan would provide an incentive for low-income taxpayers to save for higher education.

Health Savings Accounts

The Budget contains a number of proposals regarding health care, including to expand Health Savings Accounts ("HSAs"). These changes are intended by the President to make HSAs more flexible and increase the incentive to switch to HSA-compatible health care. None of the proposals would fundamentally change the basic structure of HSAs as a complement to high deductible health plans ("HDHPs").

The President proposes to:

- Modify the rules regarding qualifying HDHPs to allow plans with 50% coinsurance to qualify.
- Allow any medical expense incurred on or after the first day of HSA eligibility (rather than the date the HSA is established) to qualify for reimbursement.
- Allow larger employer contributions for the chronically ill.
- Allow family coverage to include coverage where each individual in the family can receive benefits once they have reached the minimum deductible for an individual HDHP.
- If both spouses are eligible individuals, allow both spouses to contribute the catch-up contribution to a single HSA owned by one spouse.
- Allow contributions to HSAs to be made by individuals covered by a Flexible Spending Account (FSA) or Health Reimbursement Account (HRA), but offset the maximum allowable HSA contribution by the level of FSA or HRA coverage.

The above changes would apply for tax years beginning after December 31, 2008.

Charitable IRA Distributions

The Budget proposal would make permanent the ability of IRA owners to make tax-free distributions from IRAs to qualifying charitable organizations. This provision was enacted as part of the Pension Protection Act of 2006 but expired at the end of 2007. [\[5\]](#)

Qualified Reservists Distributions

The Pension Protection Act of 2006 created an exception to the 10% penalty in Section 72(t) for withdrawals made by certain reservists called to active duty after September 11, 2001, for at least 179 days. The provision expired for individuals called to active duty after December 31, 2007. The Budget proposes to extend the provision to individuals called to active duty on or before December 31, 2009.

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endnotes

[1] A general explanation of the President's revenue proposals can be found on the U.S. Department of Treasury's website at

<http://www.treas.gov/offices/tax-policy/library/bluebk08.pdf>.

[2] See Institute [Memorandum](#) (20844) to 529 Plan Members No. 1-07, Bank, Trust and Recordkeeper Advisory Committee No. 4-07, Broker/Dealer Advisory Committee No. 8-07, Federal Legislation Members No. 1-07, Operations Members No. 6-07, Pension Members No. 8-07, Small Funds Members No. 14-07, Tax Members No. 6-07, and Transfer Agent Advisory Committee No. 8-07, dated February 6, 2007.

[3] The Pension Protection Act of 2006 made a number of the EGTRRA provisions regarding savings and pension provisions permanent. See Institute [Memorandum](#) (20250) to Pension Members No. 48-06, Federal Legislation Members No. 5-06, and 529 Plan Members No. 13-06, dated August 4, 2006.

[4] See Institute [Memorandum](#) (20844), *supra*; Institute [Memorandum](#) (19744), *supra*; Institute [Memorandum](#) (18642) to 529 Plan Advisory Committee No. 8-05, Operations Members No. 3-05, Pension Members No. 8-05, Pension Operations Advisory Committee No. 8-05, Tax Members No. 7-05 and Transfer Agent Advisory Committee No. 8-05, dated March 9, 2005; and Institute [Memorandum](#) (17042) to 529 Plan Advisory Committee No. 4-04, Operations Members No. 7-04, Pension Members No. 7-04, Pension Operations Advisory Committee No. 9-04, Tax Members No. 7-04 and Transfer Agent Advisory Committee No. 15-04, dated February 4, 2004.

[5] See Institute [Memorandum](#) (20250), *supra*.