

MEMO# 9121

August 5, 1997

THE TAXPAYER RELIEF ACT OF 1997, INCLUDING PENSION AND IRA REFORM, IS ENACTED

1 See Institute Memorandum to Tax Members No. 27-97, Accounting/Treasurers Members No. 31-97, Operations Members No. 13-97, International Members No. 12-97, Closed-end Investment Company Members No. 23-97, Unit Investment Trust Members No. 28-97 and Transfer Agent Advisory Committee No. 36-97, dated August 1, 1997. August 5, 1997 TO: PENSION MEMBERS No. 30-97 TAX MEMBERS No. 30-97 OPERATIONS COMMITTEE No. 25-97 PENSION OPERATIONS ADVISORY COMMITTEE No. 25-97 TRANSFER AGENT ADVISORY COMMITTEE No. 38-97 RE: THE TAXPAYER RELIEF ACT OF 1997, INCLUDING PENSION AND IRA REFORM, IS ENACTED

President

Clinton today signed into law the Taxpayer Relief Act of 1997. The Act contains significant IRA and pension reforms, including expansion of the deductible IRA, creation of a new back-end "Roth IRA" and creation of a new "Education IRA." These and other pension provisions in the Act are discussed below. Attachments to this memorandum include the relevant statutory language and accompanying conference report explanations. Except where specifically noted, these provisions are effective January 1, 1998. Tax provisions of interest to regulated investment companies and their shareholders are discussed in a separate memorandum.¹ The Institute is holding a one-day conference on September 22 in Washington D.C. to review the IRA, pension and tax provisions of the Act. Information on the conference will be sent to you shortly.

I. IRA Expansion (Attachment I) A. Increased Eligibility For Deductible IRAs (Attachment I-A) Section 301 of the Act increases the income limits applicable to deductible IRAs beginning in 1998 to \$30,000 for individuals and \$50,000 for couples. The income limits continue to rise gradually until the limits reach \$50,000 for individuals in 2005 and \$80,000 for - 2 - couples in 2007, thereby doubling the current income limitations applicable to deductible IRAs. A chart detailing income limitations by year is included in the attached statutory language. B. New Penalty-Free Early Withdrawals Permitted (Attachment I-B) Sections 203 and 303 of the Act permit penalty-free withdrawals from IRAs to pay for qualified higher education expenses and first-time home purchases. Withdrawals for first-time home purchases are limited to \$10,000. C. Spousal Delink (Attachment I-C) Under current law, if an individual or an individual's spouse is an active participant in a retirement plan, he or she is eligible to make deductible contributions to an IRA only to the extent that income limitations are satisfied. Section 301(b) of the Act delinks an individual's eligibility to make a deductible IRA contribution from his or her spouse's plan participation if the couple's income does not exceed \$150,000. D. Contributions to IRAs Through Payroll Deduction (Attachment I-D) The Act does not specifically address the issue of contributions to IRAs through payroll deduction.

However, the Conference Agreement states that employers that choose not to sponsor a retirement plan should be encouraged to offer a payroll deduction IRA program.

E. Permit IRAs To Invest In Bullion (Attachment I-E) Under current law, IRA assets may not be invested in collectibles, excluding gold and silver coins and coins issued by a State. Section 304 of the Act permits IRA assets to be invested in certain platinum coins and in certain gold, silver, platinum or palladium bullion.

F. Treatment Of Partnership Interests Of IRAs (Attachment I-F) Under current law, IRAs must file a return on behalf of the trust for the taxable year if the trust has \$1,000 or more of unrelated business income. Further, most partnerships are subject to the unified audit rules established by the Tax Equity and Fiscal Responsibility Act of 1982, which require the treatment of all partnership items to be determined at the partnership level, rather than at the partner level. Section 1225 of the Act modifies the filing threshold for an IRA with an interest in a partnership that is subject to the partnership-level audit rules. A fiduciary of an IRA with an interest in a partnership may treat the trust's share of partnership taxable income as gross income, for purposes of determining whether the trust meets the \$1,000 gross income filing threshold. An IRA that receives taxable income of less than \$1,000 from a partnership subject to the partnership-level audit rules is not required to file a return if the IRA has no other unrelated business income.

II. Roth IRA (Attachment II)

2 The Act adds a safe harbor for excess contributions allowing individuals to transfer excess contributions (and any allocable earnings) from a deductible IRA to a Roth IRA without income implications if the transfer is made by the due date of the individual's tax return (not including extensions).

- 3 - Section 302 of the Act creates the "Roth IRA", a new back-end IRA that is similar to the IRA Plus Account proposed by the Senate Finance Committee. Unlike the Senate Finance Committee proposal (Senate proposal) however, the Act retains the nondeductible IRA. Under the Roth IRA, individuals would be permitted to make annual nondeductible contributions in amounts up to \$2,000 to a Roth IRA. The \$2,000 contribution limit is a combined deductible IRA/Roth IRA limitation.² The Act imposes income limitations on individuals who may contribute to a Roth IRA. Eligibility to contribute to a Roth IRA phases out for individuals with adjusted gross income between \$95,000 and \$110,000 and phases out for couples with adjusted gross income between \$150,000 and \$160,000. Contributions to a Roth IRA are permitted after an individual turns 70½. Earnings accumulate tax-free in the Roth IRA. In addition, qualified distributions from the account are not includible in gross income. A qualified distribution is one made (1) after the satisfaction of a five-year holding period and (2) upon the attainment of age 59½, death, disability or for a qualified special purpose distribution. A qualified special purpose distribution is a qualified first-time homebuyer distribution. Qualified first-time homebuyer distributions are limited to \$10,000. Unlike the deductible IRA, the Roth IRA does not require distributions to commence when an individual turns 70½. Nonqualified distributions from a Roth IRA are includible in income to the extent attributable to earnings and subject to an additional 10% early withdrawal penalty, unless a qualified distribution exception applies. Like the Senate proposal, nonqualified distributions are deemed to come first from contributions and then from earnings. Finally, similar to the Senate proposal, the Act allows an individual to rollover a present-law deductible or nondeductible IRA into a Roth IRA. However, unlike the Senate proposal, the Act prohibits taxpayers with adjusted gross income in excess of \$100,000 from making a qualified rollover contribution from an IRA to a Roth IRA. For those eligible taxpayers that choose to rollover such amounts prior to January 1, 1999, the resulting amounts that would be includible in gross income may be included ratably over a four-year period. The 10% penalty tax does not apply to rollover distributions to a Roth IRA.

III. New Education IRA (Attachment III)

3 Detailed discussion of these education provisions, which include "HOPE" and "Lifetime Learning" tax credits for tuition expenses (Act section 201), restoration of the tax deduction for interest on education loans (Act section 202) and significant amendments

to section 529 qualified State tuition program provisions (Act section 211), is beyond the scope of this memorandum. 4 See Institute Memorandum to Pension Members No. 24-97, Tax Members No. 22-97, Operations Members No. 18-97, Pension Operations Advisory Members No. 18-97 and Transfer Agent Advisory Committee No. 28-97, dated June 20, 1997 for details of the Senate proposal. 5 The AGI phase-out range is identical to that established for the Roth IRA: \$95,000-\$110,000 for single filers and \$150,000-\$160,000 for joint filers. 6 "Qualified higher education expenses" are defined in Code section 529(e)(3) (as expanded by this Act) to include tuition, fees, books, supplies, and equipment required for enrollment or attendance at an eligible education institution, and room and board. (The Senate proposal to permit the use of Education IRA assets for elementary or secondary school expenses was not enacted.) In years in which an exclusion from gross income is claimed with respect to Education IRA distributions used for qualified higher education expenses, neither the "HOPE" or "Lifetime Learning" tax credits may be claimed during that year on behalf of the same beneficiary. 7 Provisions enabling the conversion of the Education IRA into a back-end IRA at age 30, which were in the Senate proposal, have been eliminated. Moreover, the Senate's proposed expansion of section 529 qualified state tuition programs to enable private schools to establish similar programs, has also been eliminated. - 4 - As part of a broader package of education-related provisions,³ the Act creates a new Education IRA. The Education IRA provision is substantially different than that which initially was proposed in both the Senate or House passed versions of the tax bill. It is, however, generally based on the Senate proposal, as described in a prior Institute memorandum.⁴ Under the Act, any individual whose modified adjusted gross income (AGI) is less than \$95,000 (\$150,000 in the case of joint filers),⁵ may contribute up to \$500 annually to an Education IRA on behalf of any child under the age of 18 that is designated the beneficiary of the account. The account must be in the form of a trust or custodial account established exclusively for the purpose of paying the "qualified higher education expenses"⁶ of the designated beneficiary. Earnings in the Education IRA build up tax-free and when distributed to pay for qualified higher education expenses are excludable from income. Contributions to an Education IRA are treated as a completed gift at the time of contribution and are eligible for the Code section 2503(b) gift tax exclusion. No contributions to the account may be made after the beneficiary attains age 18. Contributions in the aggregate to any one beneficiary may not exceed \$500 annually. Additionally, no contributions may be made on behalf of a beneficiary during any taxable year in which contributions are made by anyone to a qualified State tuition program on behalf of that same beneficiary. Qualified State tuition programs are defined in Code section 529, which also has been amended by the Act. The trustee or custodian of an Education IRA must be a bank or other institution that has demonstrated to the satisfaction of the Secretary of the Treasury that the trust or custodial account will be administered in a manner consistent with the requirements of the Internal Revenue Code. The statute specifically states that institutions that have previously so demonstrated with respect to IRAs need not seek additional government approval. Trustees and custodians are required to make reports to the Secretary and to the beneficiary with respect to contributions, distributions and other matters as the Secretary may require. Nonqualified distributions, that is distributions used to pay for other than qualified higher education expenses, are distributed and taxed in the manner provided in Code section 72(b), which sets forth the methodology for determining the extent to which amounts distributed are treated as earnings includible in gross income or basis. Nonqualified distributions, to the extent includible in gross income, are also subject to an additional 10% penalty tax. Education IRA assets may be rolled over to the account of a new beneficiary or the account itself may be converted for the use of a new beneficiary by redesignation. To the extent that the new beneficiary is a family member, as further defined in Code section 529, such rollovers and conversions are not treated as a taxable

distribution. Although the Act itself is silent as to the termination of Education IRAs, the Conference Agreement states that any balance remaining in an Education IRA at the time a beneficiary becomes 30 years old must be distributed, in which case the earnings portion of the distribution is includible in gross income and subject to the additional 10-percent penalty tax. It is unclear whether this distribution rule was intended to be in the statute.⁷ 8 See Institute Memorandum to Pension Members No. 45-96, dated September 23, 1996, discussing proposed IRS regulations implementing this standard.

- 5 -

IV. Treatment of Self-Employed's Matching Contributions in 401(k)s and SIMPLEs (Attachment IV) Under current law, matching contributions for self-employed individuals are treated as additional elective contributions to 401(k) plans, and it has been unclear whether a similar rule is applied to SIMPLE plan contributions. Section 1501 of the Act amends Code section 402(g) to exclude matching contributions on behalf of self-employed individuals from treatment as elective contributions to either a 401(k) plan or SIMPLE plan account. The rule as applied to 401(k) plans is effective for years beginning after December 31, 1997. The rule as applied to SIMPLE plans is effective retroactively to years beginning after December 31, 1996.

V. Defined Benefit Plan Limits On Involuntary Cash-Outs Raised (Attachment V) Section 1071 of the Act raises the Code section 411(a)(11) limit that prevents employers from distributing lump sum accrued benefits to individuals separating from service from \$3,500 to \$5,000. This provision is effective for plan years beginning after the date of enactment of the Act. (Prior proposals also had indexed this amount for inflation; there is no such indexation provision in the Act as passed.)

VI. Excess Distribution and Retirement Accumulation Tax Repealed (Attachment VI) Section 1073 of the Act permanently repeals the Code section 4980A "success tax," which imposed a 15% tax on excess distributions from retirement plans (those greater than \$160,000 for 1997). A similar tax on excess retirement accumulations in an individual's estate is also permanently repealed. The repeal applies to all excess distributions received after December 31, 1996 and all estates of decedents dying after December 31, 1996. (Last year's Small Business Job Protection Act had suspended the tax for a 3-year window period.)

VII. Disqualification Rule Relating to Acceptance of Rollovers Is Clarified (Attachment VII) Under current IRS regulations, a plan accepting an invalid rollover contribution will not be disqualified if the plan's administrator reasonably concluded that the rollover was from a tax-qualified plan.⁸ Section 1509 of the Act directs the Secretary of the Treasury to clarify that a plan administrator need not obtain a determination letter from the distributing plan to satisfy the "reasonableness" standard set forth in current regulations.

VIII. Directive to Develop Regulations Addressing Technologies (Attachment VIII) Section 1510 of the Act directs the Secretaries of Treasury and Labor to issue guidance designed to facilitate the use of new technologies by plan sponsors and administrators with regard to notices, elections, consent, disclosure and recordkeeping requirements set forth in the Code and ERISA and to clarify the extent to which paperless transactions are permitted under the Code. The Act requires that guidance be issued no later than December 31, 1998.

IX. New Limitations on Section 401(k) Investment in Employer Securities/Real Property (Attachment IX) Section 1524 of the Act amends ERISA section 407(b) to apply a modified form of the current 10% limitation on a plan's investment in employer securities and real property to individual account plans that were exempt from that rule. Under the Act, an individual account plan is prohibited from requiring that elective deferrals be invested in employer securities or real property. The Act provides, however, that this rule will not apply (1) to elective deferrals invested at the direction of participants, (2) to elective deferrals in amounts less than 1% of employee compensation, (3) to ESOPs, and (4) in cases where the value of all individual account plans maintained by the employer does not exceed 10% of the value of the assets of all pension plans maintained by that employer. This section of the Act is effective for plan years beginning after December 31, 1998.

X. Other Notable Pension Items (Attachment X) In

addition to the significant items discussed above, the Act contains additional pension provisions relevant to the mutual fund industry, as follows: A. ERISA's prohibition on the assignment and alienation of benefits is modified to enable the collection of penalties resulting from fiduciary violations from a participant's benefits (Attachment X-A); B. Effective as of date of enactment, the requirement to file summary plan descriptions (SPDs) and summary material modifications (SMMs) with the Department of Labor is eliminated. Plan administrators, however, must make available SPDs and SMMs upon the Department's request (Attachment X-B); C. The section 403(b) exclusion allowance is modified to conform with section 415 by providing that includible compensation includes elective deferrals and elective amounts contributed to employee benefit plans pursuant to Code sections 125 and 457. The Secretary of the Treasury also is directed to modify current regulations regarding the exclusion allowance under section 403(b)(2) to reflect section 415(e) repeal (Attachment X-C); D. The current regulatory moratorium on the application of nondiscrimination and participation rules, including the ACP and ADP tests, to State and local government plans is made permanent, effective taxable years beginning on or after the date of enactment of the Act (Attachment X-D); E. Certain water districts organized as municipal corporations are permitted to establish section 401(k) plans (Attachment X-E). XI. Other Miscellaneous Pension-Related Provisions - 6 - Finally, the additional pension-related provisions enumerated below also are included in the Act. We have not included the relevant statutory or conference agreement language for these provisions in the attachments. If you would like a copy of the relevant language, please contact the undersigned. A. The Code section 4975(a) tax on prohibited transactions is increased from 10 to 15 percent (Act section 1074); B. Code section 72 basis recovery rules for annuities are modified for annuities payable over more than one life (Act section 1075); C. ESOP provisions relating to S Corporations are modified to provide that such ESOPs may distribute cash to plan participants and extend certain exceptions to the Code section 4975 prohibited transaction rules to S Corporations (Act section 1506), and rules relating to the application of the unrelated business income tax (UBIT) to ESOPs are repealed (Act section 1523); D. The 10% tax on nondeductible contributions is modified (Act section 1507); E. Funding requirements for certain plans sponsored by interurban and interstate bus services are modified for plan years beginning after December 31, 1996 (Act section 1508); F. The full funding limit applicable to defined benefit plans is gradually increased in the years 1999 to 2005 from the current 150% to 170% (Act section 1521); G. Code section 414(e)(5) rules relating to contributions made on behalf of ministers in church plans are modified (Act section 1522); H. Code section 415 is amended as it relates to "permissive service credits" in governmental plans (Act section 1526); I. Rules relating to the payment of defined benefit plan payments for certain police and fire employees (Act section 1527), the tax treatment of survivor benefits for police killed in the line of duty (Act section 1528) and the tax treatment of disability benefits paid to former police officers and firefighters (Act section 1529) are modified. * * * * * We will keep you informed of developments. Russell G. Galer Assistant Counsel - Pension Kathryn A. Ricard Assistant Counsel - Pension Attachments (in .pdf format)