MEMO# 3648

March 27, 1992

TAX PROVISIONS OF THE MARCH 20, 1992 TAX BILL, WHICH WAS VETOED BY THE PRESIDENT

11 See Institute Memoranda to Pension Members No. 3-92, dated February 27, 1992; and to Pension Members No. 4-92, dated March 17, 1992. March 27, 1992 TO: PENSION MEMBERS NO. 5-92 RE: TAX PROVISIONS OF THE MARCH 20, 1992 TAX BILL, WHICH WAS VETOED BY THE PRESIDENT ____ This memorandum briefly describes the House-Senate compromise tax bill that was passed on March 20, 1992 and vetoed by President Bush (the "Conference Committee bill" or the "bill"). Previous memoranda describe the House and Senate versions of the bill in greater detail. 11 Anyone interested in obtaining copies of relevant Conference Committee Report and bill language may do so by calling the undersigned at (202) 955-3521. I. Individual Retirement Arrangements (IRAs) A. Reinstatement of Deductible IRA The bill would have restored the deductibility of IRA contributions under the rules in effect prior to the Tax Reform Act of 1986. The deductible amount would have been indexed in $500 increments. The limit on contributions to IRAs (both deductible and nondeductible (see below)) would have been a last dollar offset to the limit on elective deferrals to a section 401(k) cash or deferred arrangement, a section 403(b) tax- sheltered annuity or a simplified employee pension plan ("SEP"). Thus, contributions to IRAs could not exceed the difference between the elective deferral limit and the amount actually deferred. The provision would have been effective for taxable years beginning after December 31, 1992. B. Nondeductible IRAs The Conference Committee bill would have permitted the establishment of "special IRAs", which would have had - 1 - contribution limits coordinated with the limits for deductible IRAs, so that the total contributable to both would have been $2,000. In addition, the limitation would have been a last dollar offset to the limitations on elective deferrals (see section I.A., above). Withdrawals from a special IRA would have been tax free if attributable to contributions to the special IRA held for more than 5 years. The bill also would have permitted transfers from deductible to nondeductible IRAs without the 10 percent penalty for early withdrawals. If the transfer would have been made before January 1, 1994 but in a taxable year beginning after December 31, 1991, the income recognized as a result of the transfer from the deductible IRA could have been realized over 4 years. Otherwise, the income would have been recognized in the year in which the transfer were made. The bill would have been effective for taxable years beginning after December 31, 1992. As noted above, however, the provision regarding transfers to special IRAs would have been effective for taxable years beginning after December 31, 1991. Prior to January 1, 1993, therefore, the only way to have established a special IRA would have been by transferring amounts from a deductible IRA. C. Penalty-Free Withdrawals 1. Expansion of Permitted Withdrawals

from Qualified Plans for Medical Expenses to IRAs The bill would have extended to IRAs the current exception to the 10 percent early withdrawal penalty for distributions from qualified plans used to pay deductible medical expenses. In addition, penalty-free withdrawals would have been allowed from both IRAs and qualified plans for medical expenses of children, grandchildren and ancestors of the taxpayer. 2. First-Time Home Buyers The bill also would have added a new penalty free withdrawal for IRAs to the medical expense exception currently available. Penalty-free withdrawals of up to $10,000 would have been allowed if the funds were expended within 60 days of the distribution for the purchase or construction of the principal residence of the taxpayer, or the taxpayer's spouse, child or grandchild. The provision would have applied if the person for whom the residence were to have been constructed (and the person's spouse, if any) would not have owned a home within the 36-month period ending on the date the principal residence were to have been purchased or constructed and would not have been in an extended period for rolling over gain on a previous home. The waiver of the 10 percent penalty would not have been available for withdrawals from inherited or rollover IRas. Had the purchase or construction of the home been delayed, the - 2 - taxpayer would have been allowed to recontribute the withdrawal to the IRA and treat it as a qualifying rollover distribution. - 3 - 3. Educational Expenses Penalty-free withdrawals would also have been allowed from IRAs, but not from qualifying plans, for qualifying educational expenses of the taxpayer or of the taxpayer's spouse, child or grandchild. The amount of qualifying educational expenses would have been reduced by tax- exempt earnings from U.S. education savings bonds. The same restrictions on inherited and rollover IRAs would have applied as would have applied for withdrawals for first time home buyers. 4. Long-Term Unemployed The bill would have allowed penalty-free withdrawals from IRAs for certain persons who had been receiving unemployment benefits for more than twelve weeks if the withdrawal were made in the year in which the unemployment were received or the immediately succeeding year. The penalty waiver would not have been available for distributions from inherited or rollover IRAs. 5. Withdrawals During 1992 for First-Time Home Buyers and Passenger Automobile Purchases The Conference Committee bill did not include provisions which had been contained in the Senate version pertaining to penalty-free withdrawals during 1992 for home and new passenger automobile purchases. 6. Five-Year Holding Period A taxpayer would not have been allowed to make withdrawals after age 59 1/2 if the withdrawals would have been with respect to contributions made within five years of the withdrawal. The restriction would have applied only to contributions made after December 31, 1992, and withdrawals would have been considered to have come from contributions on a first-in, first-out basis. 7. Effective Dates The provisions would have been generally effective for withdrawals on or after February 1, 1992, except as described above with respect to the five-year holding period. II. Pension Simplification A. Simplified Distribution Rules 1. Rollovers Under the Conference Committee bill, any portion of a distribution to a participant or surviving spouse, other than a required minimum distribution, could have been rolled over to an IRA or another qualified plan or annuity, unless the distribution were part of a series of substantially equal payments made over the life or life expectancy of the participant or the joint lives or life expectancies of the participant and his or her beneficiary, or over a period of 10 or more years. Employee contributions could not, however, have been rolled over. - 4 - 2. Direct Transfers to IRAs or Other Eligible Transferee Plans The Conference Committee bill would have required qualified retirement or annuity plans to have allowed participant to transfer distributions eligible for rollover treatment directly to an "eligible transferee plan". An eligible transferee plan would have been an IRA or a qualified defined contribution or annuity plan but only if the transferee plan accepted such transfers. However, transfers to defined benefit plans would not have been permitted. 3. Effective Dates The provisions generally would have been effective for years beginning after 1992, except for the provision regarding direct transfers to eligible transferee plans, which would have been effective for years after 1993. B. SARSEP Provisions 1. Simplified Salary Reduction Plans for Small Employers The Conference Committee bill would have modified the rules relating to salary reduction simplified employee pensions ("SARSEPs") by providing that such SARSEPs could have been established by employers with 100 or fewer employees. The bill would have repealed the requirement that at least half of the eligible employees actually participate in the SARSEP. The bill would also have provided that an employer would be deemed to satisfy the SARSEP nondiscrimination requirements if the plan had met the safe harbor nondiscrimination rules applicable to section 401(k) plans. The SARSEP provisions would have been effective for years beginning after 1992. 2. Duties of Master and Prototype Plan Sponsors The Conference Committee bill would have given the Internal Revenue Service ("IRS") regulatory authority to define the duties of master and prototype plan sponsors and mass submitters. These duties would have become a condition of sponsoring such plans. The Conference Report to the bill stated that such duties might include maintaining annually the bill current lists of adopting employers and providing certain annual notices to the IRS and to adopting employers. Although the bill would not have authorized the IRS to mandate that the sponsor perform the administration for the funds it sponsors, the Conference Report stated that the statute was not intended to preclude the IRS from mandating the performance of specific (unidentified) functions. However, it was intended that sponsors should (1) inform employers that failure to arrange for administrative services to the plan may increase the chance of plan disqualification and legal sanctions and (2) provide the employer with a list of firms familiar with the plan which provide professional administrative services. The Conference Report also stated that the bill was not intended to create new fiduciary responsibilities under Title I of ERISA. The IRS also would have been authorized to promulgate - 5 - regulations which would have relaxed the ERISA and Code anticutback rules when an individual plan was replaced by a model plan. The master and prototype plan sponsor duty provisions would have been effective on the date of enactment. C. Nondiscrimination Provisions - Simplification of Nondiscrimination Tests for Section 401(k) Plans The Conference Committee bill would have allowed an employer to use the previous year actual deferral percentage for non-highly compensated employees in determining the current year permitted deferral percentage for the highly compensated. The bill also would have provided a safe harbor for satisfying the nondiscrimination requirements applicable to elective deferrals and employer matches. 1. Safe Harbor for Elective Deferrals Under the safe harbor, a plan would have been treated as meeting the actual deferral percentage test if the plan had met (1) one of the contribution requirements described below and (2) a notice requirement. A plan would have met the contribution requirement if either (1) the employer made a nonelective contribution to a defined contribution plan of at least 3 percent of the compensation of each eligible nonhighly compensated employee, regardless of whether the employee made elective contributions, or (2) each nonhighly compensated employee's elective contributions were matched at 100 percent for the first 3 percent of compensation deferred and at 50 percent for the next 2 percent of compensation, and the amount matched for highly compensated was not higher than for nonhighly compensated. The notice requirement would have been satisfied if each eligible employee were given written notice before each plan year of the employee's rights and obligations under the plan. 2. Safe Harbor for Matching Contributions The bill would have provided a safe harbor for meeting the special nondiscrimination test for matching contributions. The safe harbor would have been met if (1) the plan met the safe harbor for elective deferrals described above and (2) no matching contributions would be made on deferrals over 6 percent of compensation and the level of matching would not have increased as the employee's contributions or deferrals increased. The nondiscrimination provisions would have applied for plan years beginning after 1992. - 6 -

D. Miscellaneous Pension Simplification 1. Changes to Section 457 Plans The Conference Committee bill would have indexed the deferral limits under section 457 for inflation, allowed certain in-service distributions, and allowed new options as to the timing of the beginning of distributions from the plan. 2. Elimination of Half-Year Requirements The bill did not contain the provision in the Senate bill which would have eliminated all half-year requirements by rounding them down to the nearest whole year. 3. Standardization of Penalties Upon Failure to Provide Pension Information Reports Under the bill, information reports with respect to pension payments would have been treated in the same manner as other information reports. The effective date would have been for returns due after 1992. 4. Due Date for Adoption of Plan Amendments The bill would not have required plan amendments required as a result of the bill to be made until the first plan year beginning in 1994, so long as the plan were operated in accordance with the bill's provisions. E. Prohibition on State Taxation of Pension Income of Nonresidents The Conference Committee bill did not contain the Senate bill provision which would have prohibited a state from taxing the retirement income of a nonresident. We will keep you informed of developments on pension legislation. David J. Mangefrida Jr. Assistant Counsel - Tax

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