

MEMO# 9001

June 20, 1997

SENATE FINANCE COMMITTEE REVENUE RECONCILIATION BILL PENSION PROPOSALS

1 See Institute Memorandum to Pension Members No. 23-97, Tax Members No. 20-97, Operations Committee No. 17-97, Pension Operations Advisory Committee No. 17-97, Transfer Agents Advisory Committee No. 26-97, dated June 13, 1997. June 20, 1997 TO: PENSION MEMBERS No. 24-97 TAX MEMBERS No. 22-97 OPERATIONS COMMITTEE No. 18-97 PENSION OPERATIONS ADVISORY COMMITTEE No. 18-97 TRANSFER AGENT ADVISORY COMMITTEE No. 28-97 RE: SENATE FINANCE COMMITTEE REVENUE RECONCILIATION BILL PENSION PROPOSALS

On Friday, June 20, the Senate Finance Committee approved its revenue reconciliation bill for consideration by the full Senate. As previously reported¹, a similar bill was approved by the House Ways and Means Committee on June 13. This memorandum describes IRA expansion and pension proposals in the Senate bill. A separate memorandum summarizes the tax provisions of this bill relevant to Institute members. The attachment to this memorandum contains relevant excerpts from a description of the Senate Finance Committee "Chairman's Mark." Items in the Senate bill that are also included in the Ways & Means bill are starred, even where there are some differences in detail. Actual legislative language is not yet available. The Senate bill contains the following proposals: 1. IRA Expansion (Attachment 1) *A. New Back-loaded "IRA Plus" Accounts In Lieu of Nondeductible IRA The Senate Finance Committee bill would create a new back-loaded IRA, similar to the American Dream IRA proposed by the House Ways and Means Committee, and would repeal the availability of the nondeductible IRA. The IRA Plus is substantially identical to the back-loaded IRA that was proposed earlier this year by Senators Roth and Breaux in S. 197. Generally, any individual, without income or pension plan participation limitations, would be able to make an annual nondeductible contribution in amounts up to \$2,000 to an IRA Plus account. Earnings accumulate tax-free in the IRA Plus. Qualified distributions from the account are tax-free. A qualified distribution is one made after (1) the satisfaction of a five-year holding period and (2) the attainment of age 59 1/2, death, disability, or satisfaction of one of the special purpose distribution rules. The \$2,000 contribution limit is a combined deductible IRA/IRA Plus limitation. This is the most significant difference between this Senate Finance Committee proposal and the Ways & Means American Dream IRA proposal. The American Dream IRA would not require an offset of contributions to it against contributions to the traditional IRA. Under the Senate Finance Committee proposal, nonqualified distributions from the IRA Plus would be includible in income to the extent attributable to earnings and subject to an additional 10% early withdrawal penalty tax, unless a special purpose exception applies. (Under the bill, special purpose withdrawals

excepted from the 10% penalty tax are expanded. See, Section I.D. of this Memorandum.) As is the case in the House's American Dream IRA, however, nonqualified distributions are deemed to come first from contributions and then from earnings, thereby diminishing the tax consequences of such withdrawals. Like the House Ways & Means proposal, the IRA Plus proposal enables an individual to convert a present-law deductible or nondeductible IRA into an IRA Plus. If the conversion is made prior to January 1, 1999, the resulting amounts that would be includible in gross income may be included ratably over a four-year period.

B. Income limitations doubled by 2004 The bill would increase the income limitations by \$10,000 for joint filers and \$5,000 for single filers in the years 1998, 2000, and 2002, and by \$10,000 for both joint and single filers in the year 2004, thereby eventually doubling the current income limitations applicable for determining deductible IRA eligibility.

C. Delink Spousal Plan Participation Limitation Under current law, if an individual or an individual's spouse is an active retirement plan participant, he or she is eligible to make deductible contributions to an IRA only to the extent that income limitations are satisfied. The bill would delink an individual's eligibility to make a deductible IRA contributions from his or her spouse's plan participation.

***D. New Penalty-free Early IRA Withdrawals Permitted** (See Attachment 2) The bill would permit penalty-free withdrawals from both traditional and back-end IRA accounts to pay for higher education expenses, first-time home purchase or in cases of long-term unemployment. Unlike the House Ways & Means bill, withdrawals for first-time home purchase are limited to \$10,000. The House Ways & Means bill also does not provide for a long-term unemployment exception to the 10% penalty tax.

E. Contributions to IRAs Through Payroll Deduction (Attachment 1A) The bill would clarify that employers may permit employees to make contributions to IRAs through payroll deduction at the workplace. The bill further provides that an employer offering such a program will not be considered to be offering a retirement plan subject to ERISA, and therefore, is not subject to ERISA's fiduciary rules.

2. New Education IRA (Attachment 2) The bill would enable individuals to make contributions of a proposed annual \$500 child tax credit and additional, annual nondeductible amounts up to \$2,000 per child to either an Education IRA or section 529 qualified tuition program up until the child reaches age 18. Only one Education IRA or qualified tuition program may be opened for each child. Amounts would build up tax-free in the account and when distributed to pay for qualified higher education expenses would be excludable from income. Individuals with children between the ages of 13 and 16 would be required to save the \$500 credit in an Education IRA in order to obtain the credit. Unlike the contributions to the Ways & Means Committee's proposed Education Investment Accounts, contributions to an Education IRA would not be considered taxable gifts subject to Federal gift tax rules. The value of the account would be includible in the estate of the account beneficiary, but in no event in the estate of a contributor. In each tax year, a taxpayer may elect with respect to an eligible student either the HOPE tax credit (assuming eligibility for the credit) or the proposed exclusion from income of distributions from an Education IRA or a section 529 qualified tuition program used to pay "qualified higher education expenses." Balances remaining in an Education IRA or qualified tuition program must be distributed when the beneficiary becomes 30 years old or dies. These distributions may be rolled over tax-free into an IRA of the beneficiary or into an Education IRA for a family member of the beneficiary. A 10% penalty tax would be imposed on distributions from an Education IRA or qualified tuition program to the extent the distribution exceeds qualified higher education expenses paid by the taxpayer. The penalty tax would not apply if the distribution is made on account of death, disability or scholarship received by the beneficiary. The proposal would be effective for distributions made and qualified higher education expenses paid after December 31, 1997 for education furnished in academic periods beginning after that date. Please note, this proposal is part of a comprehensive series of education-related proposals that are beyond the scope of this

memorandum. Additionally, this proposal is substantially different in detail from the Education Investment Accounts proposed in the House Ways and Means Committee's revenue reconciliation bill. 2 It remains unclear from the Committee description of this proposal whether or not it is intended to address similar application of the elective deferral rule to SIMPLE IRA plans. 3. Matching Contributions For Self-Employed Individuals (Attachment 3) The bill would provide that matching contributions for partners in 401(k) plans will be treated the same as matching contributions for employees and therefore, no longer treated as elective deferrals subject to the elective deferral limit.² 4. Section 4980A Excess Distribution Tax Repeal (Attachment 4) The bill would repeal the so-called "success tax," a 15% tax on excess distributions from pensions and excess accumulation tax on pension assets. Last year's Small Business Job Protection Act had created a 3-year window period during which the tax is suspended. *5. Defined Benefit Plan Cashout Limits Raised (Attachment 5) The bill would raise the limitation that prevents employers from distributing lump sum accrued benefits to individuals separating from service from \$3,500 to \$5,000, and also would index the limitation for inflation. 6. Other Pension Provisions (Attachment 6) The bill would also provide as follows: A. Clarify the circumstances under which a qualified plan may accept a rollover contribution without jeopardizing its qualified status; B. Modify ERISA's prohibition on the assignment or alienation of benefits to enable the collection of penalties resulting from fiduciary violations; C. Eliminate the requirement that Summary Plan Descriptions and Summary Material Modifications be filed with the Department of Labor, except upon request of the Department; D. Modify the section 403(b) exclusion allowance to conform it to the manner in which section 415 is calculated, by providing that includible compensation includes elective deferrals and elective employee contributions made to certain unfunded deferred compensation plans; E. Direct the Secretaries of the Treasury and Labor to issue guidance to facilitate the use of new technologies (voice response systems, computers, e-mail) for retirement plan administrative purposes and to clarify the extent to which the writing requirements under the Internal Revenue Code may be interpreted to permit paperless transactions; *F. Make permanent the moratorium on the application of nondiscrimination rules to State and local government plans; G. Modify certain ESOP provisions relating to S Corporations to provide that such ESOPs may distribute cash to plan participants and to extend certain exceptions to the prohibited transaction rules to S corporations; H. Modify the 10% tax on nondeductible contributions; *I. Modify the \$1,000 filing threshold for an IRA with unrelated business income derived from certain investment in partnerships (see Attachment 6A); *J. Clarify that the marital deduction is available with respect to a nonparticipant spouse's interest in an IRA, SEP or qualified retirement plan attributable to community property laws where such spouse predeceases the participant spouse and the nonparticipant spouse's interest in the plan is deemed to qualify for treatment as qualified terminable interest property (QTIP) under Code section 2056(b)(7) (see Attachment 6B); and, 7. Other Pension Items Added By Amendment (Attachment 7) Additional provisions, which were added to the Finance Committee bill by amendment, would A. Require spousal consent for distributions from 401(k) plans where the distribution is other than in the form of periodic payments; B. Permit IRAs to invest in bullion; C. Increase the prohibited transaction excise tax from 10 to 15 percent; D. Increase the full funding limit applicable to defined benefit plans from the current 150% to 170% (phased up over the years 1999-2005); E. Modify the basis recovery method for annuity payments; F. Permit certain non-denominational plans to exclude ministers from nondiscrimination testing where the minister participates in a church plan; and G. Provide that contributions made on behalf of a minister are excludable from the income of the minister. We will keep you informed of developments. Russell G. Galer Assistant Counsel - Pension Attachment Note: Not all recipients of this memo will receive an attachment. If you wish to obtain a copy of the attachment referred to in this memo, please call the Institute's

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