

**MEMO# 7356**

October 26, 1995

## **STATUS OF 1995 PENSION LEGISLATIVE PROPOSALS**

1 See Institute Memorandum to Pension Members No. 7-95 dated January 16, 1995, and Institute Memorandum to Pension Members No. 17-95 and Tax Members No. 17-95, dated March 20, 1995. 2 See Institute Memorandum to Pension Committee No. 16-95, dated September 27, 1995 and Institute Memorandum to Pension Committee No. 13-95, dated July 25, 1995. October 26, 1995 TO: PENSION MEMBERS No. 43-95 OPERATIONS COMMITTEE No. 30-95 TRANSFER AGENT ADVISORY COMMITTEE No. 52-95 RE: STATUS OF 1995 PENSION LEGISLATIVE PROPOSALS

This memorandum summarizes the status of various IRA, small employer pension, and pension simplification legislative proposals, as reflected in bills approved by the Senate Finance Committee and House Ways and Means Committee. On October 19, 1995 the Senate Finance Committee approved tax proposals that include a "back-loaded" IRA called the "IRA Plus", which is similar to the American Dream Savings Account bill passed by the House earlier this year.<sup>1</sup> The Finance Committee also approved Senator Doles retirement plan legislation for small employers, the Savings Incentive Match Plan for Employees ("SIMPLE"), and portions of the pension simplification legislation previously proposed by Senators Pryor and Hatch in S. 1006. The SIMPLE plan legislation replaces SARSEP proposals that were in the original Pryor-Hatch bill.<sup>2</sup> On September 18, 1995, the House Ways and Means Committee approved pension simplification provisions, many of which are similar to those in the Senate Finance Committee bill.

I. Back-loaded IRA Proposals The Senate Finance Committee proposes to replace the current non-deductible IRA with an "IRA Plus" account, which would provide tax free withdrawals of assets from the account after age 59½. Under the proposal, contributions to the IRA Plus account are nondeductible and coordinated with the contribution limits for deductible IRAs. Contributions to an IRA Plus account must remain in the account for 5 years, subject to penalties for withdrawal as described below. For the purpose of calculating the 5-year holding period, all contributions for a taxable year are treated as made on January 1 of that year. Earnings on the account are allocated to each years contributions under methods to be described in regulations. Assets withdrawn from the IRA Plus account are treated as withdrawn in the order deposited, with the oldest assets withdrawn first.

3 House Ways and Means bill, however, does include pension simplification provisions relevant to small employers, particularly with regard to salary reduction simplified employer pensions (SARSEPs). Similar SARSEP provisions were struck from the Senate Finance Committee bill.

- 2 - As proposed, withdrawals from the IRA Plus of assets that have been in the account for less than five years are includible in income (to the extent of earnings) and are subject to a 10-percent early withdrawal tax. Withdrawals made after the satisfaction of the 5-year period and before the individual is age 59½ are

excludible from income and not subject to the 10-percent early withdrawal tax only if the withdrawal is on account of death, disability, in the form of annuity or made for a "special purpose." Special purpose distributions include distributions for certain first-time home purchase costs up to \$10,000, higher education fees, extraordinary medical expenses, or certain unemployed individuals. Withdrawals after 5 years and after age 59½ are not includible in income or subject to the 10% penalty regardless of the purpose of the withdrawal. Under the proposal, individuals may withdraw assets from present IRAs and roll them over into an IRA Plus account without incurring a 10% early withdrawal penalty. Such amounts, however, would be includible in gross income in the year of the roll over. A window period is provided that would permit the income to be includible ratably over 4 years if rolled over before January 1, 1998. The House "American Dream Savings Account" (ADS Account) is similar to the IRA Plus. It would permit individuals to make a non-deductible annual contribution of up to \$2,000 (\$4,000 for married couples filing jointly) to an ADS Account. As with the Senate Finance Committee proposal, for withdrawals to be exempt from income and penalty tax, a 5-year holding period must be satisfied in addition to an age 59½, death or disability, or special purpose requirement. These proposals differ in minor details and will have to be reconciled as the legislation moves forward.

## II. Deductible IRA Legislation

The Senate Finance Committee proposal also modifies current deductible IRA rules. Income limits on the deductibility of IRAs would be phased up over ten years to \$85-95,000 for single individuals and to \$100-120,000 for married couples, and indexed for inflation in \$5,000 increments thereafter. Additionally, the \$2,000 limit on contributions that could be made to an IRA is indexed for inflation in \$500 increments. This limit would apply to the combined contributions made by an individual to both the deductible IRA and IRA Plus. Under the Senate Finance Committee proposal, married couples are eligible to make IRA contributions of up to \$2,000 for non-employed spouses and an individual's active participation in a pension plan would not disqualify a spouse's eligibility for an IRA deduction. The House proposal would also expand spousal access to IRAs, although the bill differs in detail from Senate Finance's. Both the Senate Finance and House Ways and Means bills permit penalty-free early withdrawals from deductible IRAs for certain "special purposes" as described above regarding the IRA Plus account.

## III. Small Employer "SIMPLE" Plan Proposed

The Senate Finance Committee bill includes small employer pension plan legislation proposed by Senator Dole. No similar legislation has passed in the House or been approved by the House Ways and Means Committee.

### 3 - 3 - Under the proposal, employers with 100 or fewer employees, who do not maintain another employer-sponsored retirement plan, may establish a "SIMPLE" retirement plan in either IRA or 401(k) form. In IRA form, employee contributions expressed as a percentage of income cannot exceed 6%; the employer must match the first 3% of the employee contribution, or upon notice to employees, may reduce the match to as little as 1%. The employer, however, may elect matching percentages below 3% in no more than 2 out of any 5 year period. All employees who have received at least \$5,000 in compensation from the employer in each of the preceding two years are eligible to participate in the plan. All contributions are fully vested upon contribution. Distribution rules are similar to tax-deductible IRA rules, except that the early withdrawal tax increases from 10 to 25 percent for distributions made from the SIMPLE account within the first two years of the accounts establishment. The proposal imposes certain annual reporting requirements on SIMPLE account trustees, including the provision of annual summary descriptions, account statements and annual reports to the IRS similar to those required for IRAs. For SIMPLE 401(k) plans, similar rules apply. In addition, the nondiscrimination and top-heavy rules are waived provided the following safe harbor is met: employee elective deferrals are limited to no more than \$6,000 and the employer matches the deferral up to 3% of compensation. In contrast to the SIMPLE IRA proposed, in its 401(k) form, the employer cannot decrease the match below 3% at any

time. To encourage the establishment of SIMPLE plans, the bill provides a pension plan start-up tax credit for 50 percent of qualified costs, up to \$500, for an eligible employer who establishes a SIMPLE plan.

#### IV. Pension Simplification Provisions

Both the House Ways and Means Committee and Senate Finance Committee bills contain numerous "pension simplification" items, including the following:

1. Both bills modify the minimum distribution requirement by permitting a delay of such distributions for an active employee who has attained age 70½ until April 1 of the calendar year following the year in which the employee retires; a corresponding actuarial adjustment is required. This provision would be inapplicable to five-percent owners.
2. Both bills simplify the definition of highly compensated employee to include only (i) 5% owners of the employer, (ii) those with compensation in excess of \$80,000 (indexed for inflation) in the preceding year, and (iii) the person who was the most highly compensated officer for the preceding year.
3. Both bills create a design-based, nondiscrimination safe harbor applicable to elective deferrals and employer matching contributions. Under the House Ways and Means safe harbor, a plan must provide matching contributions (a) equal to 100% of the employees elective contribution up to 3% of compensation and (b) a 50% match for contributions from 3 to 5% of compensation. Additional requirements are established, however, if the matching contributions for highly compensated employees are greater than the match rate for non-highly compensated employees at any level of compensation. Under these safe harbor rules, all contributions are nonforfeitable. These safe harbor rules would be available to SARSEPs.
4. The Senate Finance Committee bill permits the use of non-discrimination safe harbors for 401(k) plans providing either a minimum contribution equal to 3% of compensation for all participants or providing matching contributions to the same extent as required in the House Ways and Means bill. All contributions are nonforfeitable. The safe harbor would not be available to SARSEPs.
5. The House Ways and Means bill modifies the method to distribute excess contributions. The total amount of excess contributions to a plan would be determined in the same manner as under present law, however, the method of allocating the excess contributions to particular employees is changed. Excess contributions would be deemed attributable first to those highly compensated employees who have made the greatest dollar amount of elective deferrals under the plan, thereby reducing the impact of the correction on the lower paid, highly compensated employees. This provision is not in the Senate Finance Committee bill.
6. The House Ways and Means bill modifies rules applying to simplified employee pensions (SEPs). The bill permits SARSEPs to be established by employers with 100 or fewer employees, repeals the 50% participation requirement for SARSEPs, permits the use of prior year actual deferral percentage data for nondiscrimination testing, and permits SARSEPs to use the design-based safe harbors available to 401(k) plans. These provisions are not in the Senate Finance Committee bill, which establishes "SIMPLE" plans instead.
7. The Senate Finance Committee bill clarifies the treatment of excess deferrals in 403(b) plans by stating that excess deferrals of one employee of an employer will not affect application of section 403(b) to other employees of the employer. Further, if there is an excess deferral, only the excess over the section 402(g) limit would be includible in the employee's income if certain other criteria are met. This provision is not included in House legislation.
8. Other items in both bills include: (1) repeal of the combined plan limit under section 415(e); (2) repeal of the family aggregation rules; (3) expansion of 401(k) plan availability to nongovernmental tax-exempt organizations; (4) sunset of 5-year averaging for lump-sum distributions from qualified plans; (5) repeal of the \$5,000 death benefit exclusion; (6) modification of the section 401(a)(26) minimum participation rules to apply only to defined benefit plans; (7) modification of the "leased employee" definition based on a "direction or control" standard; (8) extension of section 420 to permit transfers of excess defined benefit plan assets; (9) elimination of the special aggregation rules that apply to plans maintained by self-

employed individuals; and (10) modification of the treatment of governmental plans under sections 415 and 457. Many of the Senate Finance and House Ways and Means simplification provisions differ in some details and in proposed effective dates. If you would like copies of available bill language or committee explanations of bill provisions, please contact the undersigned. We will keep you informed of progress on this legislation. Russell G. Galer Assistant Counsel - Pension - 5 -

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