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PRESIDENT'S SAVINGS AND RETIREMENT SECURITY PROPOSALS

[15601] January 31, 2003 TO: 529 PLAN ADVISORY COMMITTEE No. 7-03 OPERATIONS MEMBERS No. 4-03 PENSION MEMBERS No. 7-03 TAX MEMBERS No. 7-03 TRANSFER AGENT ADVISORY COMMITTEE No. 13-03 RE: PRESIDENT'S SAVINGS AND RETIREMENT SECURITY PROPOSALS Treasury released today the attached description of the President's new savings and retirement security proposals. These proposals will be included in the President's budget, which is scheduled to be released on Monday, February 3, 2003. The President's plan calls for the creation of three new savings vehicles: a Lifetime Savings Account (LSA), a Retirement Savings Account (RSA) and an Employer Retirement Savings Account (ERSA). Lifetime Savings Account Lifetime Savings Accounts would be individual savings accounts that could be used for any type of saving. In many respects, LSAs would be taxed like Roth IRAs. Taxpayers, regardless of age or income, could make nondeductible contributions to an LSA of up to $7,500 per year (indexed for inflation), even if they have no wage income. Taxpayers also could make an LSA contribution on behalf of any other individual. However, total contributions made on behalf of an individual to an LSA could not exceed $7,500. No tax would be imposed on either earnings in an LSA or on distributions from an LSA. Moreover, as LSAs have no holding period requirement, penalty-free withdrawals could be made at any time. Also, LSAs would not be subject to a required minimum distribution requirement during the taxpayer's life. An LSA could be held in the form of a nontransferable annuity contract issued by an insurance company that met the rules that currently apply to individual retirement annuities. Prior to January 1, 2004, individuals would be permitted to convert balances in an Archer Medical Savings Account (MSA), Coverdell Education Savings Account (Coverdell ESA) and Qualified State Tuition Plan (529 Plans) to LSAs. Balances in these accounts could not be 2 converted to LSAs after 2003.1 Taxpayers who do not convert their MSAs, Coverdell ESAs and 529 Plans may continue to contribute to them. In the case of a 529 Plan or Coverdell ESA conversion, no amount would be taxable in the year of the conversion. A conversion of an MSA to an LSA would result in taxation of the total amount converted in the year of the conversion. The trustee rules that now apply to IRAs would apply to LSAs. Thus, the trustee would have to be a bank or another person who demonstrates to the IRS that the manner in which they would administer the trust would be consistent with the rules applicable to LSAs. The Saver's Credit would be available for elective deferrals and LSA contributions made prior to 2007. Catch-up contributions would not be available for LSAs. Retirement Savings Account Retirement Savings Accounts (RSAs) would be individual accounts that could be used only for retirement savings. The RSA would effectively consolidate traditional IRAs, nondeductible IRAs and Roth IRAs into a single account, which would be subject to rules similar to the rules currently applicable to Roth IRAs. RSAs would not be subject to income limits or required minimum distribution requirements. Taxpayers, regardless of age or

income, would be able to make nondeductible contributions to an RSA of up to $7,500 per year (indexed for inflation). This amount is in addition to contributions to an LSA. Taxpayers also could make an RSA contribution on behalf of any other individual. However, total contributions made on behalf of an individual to an RSA could not exceed $7,500 or compensation income, if less. In the case of a married couple filing jointly, RSA contributions up to $7,500 could be made for each spouse (including, for example, a homemaker who does not work outside the home) if the combined compensation of both spouses were at least equal to the contributed amount. While there would be no maximum income limitations on making contributions to RSAs, taxpayers could not contribute more than compensation income (wages) to an RSA. An RSA could be held in the form of a nontransferable annuity contract issued by an insurance company that met the rules that currently apply to individual retirement annuities. Existing Roth IRAs would be unaffected, except that they would be renamed RSAs. No tax would be imposed on either earnings in an RSA or on qualified distributions from an RSA after age 58 (or death or disability). Nonqualified distributions in excess of plan contributions would be included in income and subject to additional tax. Traditional and nondeductible IRAs could be converted into RSAs at any time, but there would be no conversion requirement. The amount converted would be taxable except to the extent that a taxpayer has basis in his or her IRA. If a taxpayer converted to an RSA prior to January 1, 2004, then he or she would be able to spread the tax on the conversion over a four- year period. For conversions on or after January 1, 2004, the total taxable amount would be included in the taxpayer's gross income for the year of the conversion. 1 Under the President's proposal, LSAs and RSAs would be effective for tax years beginning in 2003. 3 Traditional and nondeductible IRAs not converted to RSAs would not be able to accept any new contributions, except for rollover contributions. New traditional IRAs could be created solely to accommodate rollovers from employer plans. The trustee rules that now apply to IRAs would apply to RSAs. Thus, the trustee would have to be a bank or another person who demonstrates to the IRS that the manner in which they would administer the trust would be consistent with the rules applicable to RSAs. The Saver's Credit would be available for elective deferrals and RSA contributions made prior to 2007. Deemed IRAs would become deemed RSAs and would be subject to the rules applicable to RSAs. Catch-up contributions would not be available for RSAs. Employer Retirement Savings Accounts The President's proposal would consolidate 401(k), thrift, 403(b) and governmental 457 plans2, SARSEPs and SIMPLE IRAs into a single employer-sponsored account called an Employer Retirement Savings Accounts (ERSA), which could be sponsored by any employer.3 Beginning in 2004, all 401(k) plans would become ERSAs. SIMPLEs, SARSEPs, 403(b) plans and governmental 457 plans could continue in existence indefinitely, but could not accept any future contributions after 2004. The ERSA proposal would not change existing rules governing pure profit sharing plans, stock bonus plans and money purchase plans. 4 ERSAs would be subject to simplified versions of the existing rules applicable to 401(k) plans. For example, the proposal envisions that both the definition of compensation and the minimum coverage requirement would be simplified. The top-heavy rules would be repealed. Nondiscrimination requirements for ERSA contributions would be satisfied by a single test and firms could choose to adopt a new designed-based safe harbor to avoid this test. An employee would be able to defer in an ERSA up to $12,000 (increasing to $15,000 in 2006) plus, once the employee reaches age 50, a catch-up contribution of $2,000 (increasing to $5,000 in 2006). After-tax contributions would be permitted to an ERSA, and accounts attributable to such contributions made after 2003 would be treated much like the new RSAs. Distributions from such accounts would generally be exempt from taxation and the accounts would not be subject to the required minimum distribution rules until after the death of the participant. ERSAs would be subject to a ratio-percentage nondiscriminatory coverage requirement. Under this test, the percentage of an employer's nonhighly compensated employees covered under a plan would have to be at least 70% of the percentage of the employer's highly compensated employees covered under the plan. The other coverage testing alternatives would be repealed. An ERSA would also be subject to a nondiscriminatory benefit requirement. In cases where the average contribution percentage for nonhighly compensated employees is no greater 2 ERSAs would essentially replace all types of funded plans with employee contributions. Thus, ERSAs would not replace nongovernmental 457 plans. 3 ERSAs would become effective for tax years after December 31, 2003. 4 Defined benefit plans also are not affected by this consolidation proposal. 4 than 6%, then the average contribution percentage for highly compensated employees could not exceed 200% of the average contribution percentage for nonhighly compensated employees. In cases where the average contribution percentage for nonhighly compensated employees is greater than 6%, then the average contribution percentage for highly compensated employees could be any amount. ERSAs covering only employees of state and local governments would be exempt from the nondiscriminatory benefit requirement. An ERSA covering only employees of a charitable organization would be subject to the nondiscriminatory benefit requirement only if it allowed after-tax contributions. In addition, an ERSA covering employees of a charitable organization would be subject to a universal availability requirement regarding the ability of employees to make deferrals under the ERSA that would require that all employees of the organization be permitted to elect to make deferrals of more than $200. If an ERSA satisfied a safe-harbor exception, then it would not have to satisfy the general nondiscriminatory benefit rule. An ERSA would satisfy the safe harbor if it met any of the following requirements: 1. The employer makes a nonelective contribution on behalf of each participant in the plan equal to 3% of the employee's compensation, 2. The employer makes a matching contribution equal to 50% of each employee's deferrals (up to 6% of compensation), or 3. The employer makes a matching contribution that does not increase based on the level of an employee's deferrals and the match is equal to the amount that would be made under a 50% match (up to 6% of compensation), such as a match of 100% of each employee's deferrals (up to 3% of compensation). Compensation for all purposes for all defined contribution plans (e.g. ERSAs or 403(b), SIMPLE plans, etc., that remain in effect) would be defined as the amount reported on IRS Form W-2 for wage withholding, plus the amount of ERSA deferrals. A new definition of "highly compensated employee" for all defined contribution plans would include all individuals with compensation for the prior year above the Social Security wage base for that year. Permitted disparity and cross-testing would not be permitted for any defined contribution plan. Lisa Robinson Assistant Counsel Note: Not all recipients receive the attachment. To obtain a copy of the attachment, please visit our members website (http://members.ici.org) and search for memo 15601, or call the ICI Library at (202) 326-8304 and request the attachment for memo 15601. Attachment (in .pdf format)
