MEMO# 7435

November 20, 1995

CONGRESS PASSES IRA AND PENSION LEGISLATION

1 See Institute Memorandum to Pension Committee Members No. 43-95, Operations Committee No. 30-95, and Transfer Agent Advisory Committee No. 52-95, dated October 26, 1995. November 20, 1995 TO: PENSION MEMBERS No. 47-95 OPERATIONS COMMITTEE No. 33-95 TRANSFER AGENT ADVISORY COMMITTEE No. 59-95 RE: CONGRESS PASSES IRA AND PENSION LEGISLATION

____ Congress is expected to pass IRA and pension legislation as part of its Revenue Reconciliation Act of 1995. The bill contains many of the items reported in previous Institute memoranda.1 Most notably, the bill (1) replaces the non-deductible IRA with a "back-loaded" IRA called the American Dream IRA; (2) phases up the income limitations for deductible IRAs, expands availability of IRAs to non-working spouses and permits "special purpose" withdrawals from IRA accounts; (3) creates a new small employer retirement vehicle ("SIMPLE" plans), which would replace SEP provisions; (4) creates Medical Savings Accounts; and (5) contains many of the pension simplification provisions contained in previous House and Senate bills. The President is expected to veto this bill. Following the veto, negotiations over the budget will continue. It is unclear which of these provisions will survive the negotiations. I. Non-deductible, Tax-free IRA: American Dream Savings Account The bill contains a "back-loaded" IRA similar to the American Dream Savings Account passed by the House earlier this year. Under the bill, all individuals (including non-employed spouses) may make non-deductible contributions up to $2,000 a year to an American Dream IRA (AD-IRA). The maximum permitted contribution would be reduced by any deductible IRA contribution for the year. Withdrawals from the AD-IRA account are tax-free and penalty-free if the account holder is at least 59 1/2 and the account has been established for at least five years. If the account holder is under age 59 1/2 and the five-year period has been satisfied, withdrawals are tax-free and penalty-free if for a qualified special purpose, such as certain medical expenses, higher education costs, first-time home purchase, or periods of unemployment. If the five-year period is not satisfied, withdrawals for such special purposes will be subject to taxation, but would be penalty-free. All other withdrawals are taxable and subject to a 10-percent penalty. The bill permits individuals to withdraw assets from present IRAs and roll them over into an AD-IRA account without incurring a 10 percent early withdrawal penalty. Such amounts, however, would be includible in gross income in the year of the rollover. 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 effective date is January 1, 1996. II. Deductible IRA Legislation The bill modifies current deductible IRA rules. Income limits on the deductibility of IRAs would be phased up by $5,000 a year until the phase-out range reaches $85-95,000 for single individuals and $100-120,000 for married couples. Indexing after the $85,000 and $100,000 thresholds are reached is in $1,000 increments. The $2,000 annual limit on IRA contributions 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 AD-IRA. 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. Penalty-free early withdrawals from deductible IRAs for certain "special purposes", as described above regarding the AD-IRA, would be permitted. The effective date is January 1, 1996. III. Small Employer "SIMPLE" Plan Proposed; SEP Repeal The bill adopts the Savings Incentive Match Plan for Employees (SIMPLE) and repeals SEP provisions. The SEP repeal, which was not in any prior bill, would permit currently established SEPs to continue. SIMPLE plans in either IRA or 401(k) type form may be established by employers with 100 or fewer employees, who do not maintain another employer-sponsored retirement plan. Under the IRA-type SIMPLE provisions, employee contributions expressed as a percentage of income cannot exceed $6,000; the employer must match the first 3 percent of the employee contribution, or upon notice to employees, may reduce the match to as little as 1 percent. The employer, however, may elect matching percentages below 3 percent 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. Matching contribution requirements are slightly different for 401(k)-type SIMPLEs. 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 contains certain annual reporting requirements for SIMPLE account trustees, but also includes amendments to Title I of ERISA that would eliminate other ERISA reporting requirements and limit fiduciary duties. A proposed tax credit for employers establishing SIMPLE plans was eliminated in conference. The effective date of this provision is January 1, 1996. IV. Medical Savings Accounts The bill permits the establishment of Medical Savings Accounts (MSAs). Contributions to an MSAs are deductible. Earnings on the MSA are not currently taxable. Distributions for medical expenses are not taxable. Distributions from an MSA for non-medical purposes would be includible in income and subject to a 10-percent excise tax unless made after age 59 1/2, death or disability. The effective date is January 1, 1996. V. Pension Simplification Provisions Many of the simplification items in previous bills are in this reconciliation package including, among other items, (1) addition of 401(k) non-discrimination safe-harbors with a delayed effective date of January 1, 1999; (2) repeal of the combined plan limits under Section 415(e) with a delayed effective date of January 1, 1999; (3) repeal of the $5,000 death benefit exclusion; (4) modification of the minimum distribution rule; and(5) expansion of 401(k) plan availability to all tax-exempt organizations (but not State and local governments) with an effective date of January 1, 1997. Also of note, legislation regarding source state taxation of retirement income, although included in previously passed bills, was not included in the conference bill. We will keep you informed of progress on this legislation. 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 Information Resource Center at (202)326-8305 or (202)326-5903, and ask for this memo's attachment number: 7435.

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