INVESTMENT COMPANY INSTITUTE

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PRESIDENT'S FISCAL-YEAR 2000 BUDGET CONTAINS SIGNIFICANT RETIREMENT SECURITY AND TAX PROPOSALS

[10721] February 12, 1999 TO: BOARD OF GOVERNORS No. 7-99 FEDERAL LEGISLATION MEMBERS No. 4-99 PRIMARY CONTACTS - MEMBER COMPLEX No. 13-99 PUBLIC INFORMATION COMMITTEE No. 3-99 RE: PRESIDENT'S FISCAL-YEAR 2000 BUDGET CONTAINS SIGNIFICANT RETIREMENT SECURITY AND TAX PROPOSALS ____ On February 2, President Clinton released his fiscal-year 2000 budget proposal. It includes a series of provisions relating to retirement security, private pension plan coverage, tax-related matters of interest to the investment company industry, and SEC funding. The President's budget serves as a starting point for further budget and policy discussions and indicates the Administration's positions on a variety of issues. However, none of these proposals has yet been introduced as part of a legislative package. Retirement and Pension Issues The budget includes the following provisions related to retirement and pension security: Portability. Rollovers between and among qualified plans and between qualified plans and IRAs would be facilitated. Rollovers of after-tax contributions to another qualified plan or traditional IRA would be allowed provided the plan or IRA provider agrees to track and report the after-tax portion of the rollover for the individual. Payroll deductible IRAs. Employee contributions of up to $2,000 made to an IRA through payroll deduction would be excluded from taxable income (rather than being deducted from income on the individual's tax return). Small business tax credit. Small businesses establishing pension programs would be eligible for a tax credit of 50 percent of administrative and retirement education expenses associated with plan sponsorship, up to $1,000 in the first year and $500 in the second and third years. SMART defined benefit plans. Small businesses with 100 or fewer employees would be allowed to offer a simplified defined benefit plan, the Secure Money Annuity or Retirement Trust (SMART). Plan participants would be guaranteed a minimum annual benefit upon retirement. Faster 401(k) vesting. All employees participating in a 401(k) plan would be fully vested in the employer's matching contributions after three years of service (current law is five years) or over six years of service if vesting is incremental (current law is seven years). Family and medical leave. Leave taken under the Family and Medical Leave Act would be counted in determining retirement plan eligibility and vesting. Joint and seventy-five percent survivor annuity option. Plans that are required to provide a joint and survivor annuity option to participants would be required to offer, as an option, a joint and seventy-five percent survivor annuity. Pension "Right to Know". Explanation of a plan's survivor benefits would have to be provided to both the participant and the participant's spouse. Employers utilizing a 401(k) safe harbor plan design would also be required to provide notice and election to participants in timeframes and in a

manner similar to what is required for SIMPLE plans. Floor contribution requirement. Employers taking advantage of the 401(k) safe harbor matching plan design would be required to make a contribution of 1 percent of compensation for each eligible nonhighly compensated employee, regardless of whether the employee contributes to the plan. Definition of highly compensated employee. The definition of highly compensated employee would be changed to one that looks to whether the employee was a 5 percent owner of the employer or had compensation in excess of $80,000. Plans would no longer be allowed the option of looking to see which employees were in the "top paid group" for purposes of determining highly compensated status. Elective withholding rate for non-periodic distributions. The elective withholding rate for non-periodic distributions (e.g., lump-sum distributions) from deferred compensation plans would be increased from 10 percent to 15 percent. However, the recipient retains the ability to elect not to have the withholding apply to his or her distribution. Increase in excise tax on excess IRA contributions. Excise tax on excess contributions (those above $2,000) to traditional and Roth IRAs would be increased from 6 percent to 10 percent. ERISA’s limited scope audit. The budget proposal also indicates the intent on the part of the Administration to introduce legislation to improve the audits of private pension plans. At this time, it is unclear whether this means that the Administration is proposing to repeal the limited scope audit, or is seeking other reform measures that affect the auditing of pension plans. 3Tax Issues The President’s budget also includes several tax issues of interest: Flow-through of interest income. For the second year, the President’s budget proposes to exempt from U.S. withholding tax all distributions made to foreign investors from those bond funds investing "substantially all" of their assets in U.S. debt securities or cash (with some unspecified level of foreign bond investment also being permissible). The proposal would eliminate the present law incentive that foreigners have to receive interest and short-term gains through direct investments or through foreign funds (where the income is exempt), rather than through a U.S. fund (where it is converted to dividend income subject to U.S. withholding tax). Mandatory accrual of market discount. Accrual basis taxpayers would be required, under the President’s proposal, to include market discount in income as it accrues. Under present law, these taxpayers would take market discount in income only when the debt instrument acquired with market discount is sold. Investment income of trade associations. Trade associations would be subject to tax each year on their net investment income in excess of $10,000. SEC Receives Increased Funding The President’s budget proposes $363 million for the Securities and Exchange Commission in FY2000, $5 million above the current fiscal year. Under the National Securities Markets Improvement Act of 1996, on October 1, 1999, the SEC registration fee rates for FY2000 will drop to .000264 (approximately 1/38 of one percent) from the current level of .000278. We will keep you informed of further developments. Matthew P. Fink President

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