MEMO# 8987

June 13, 1997

# HOUSE WAYS AND MEANS COMMITTEE PENSION LEGISLATION

1 See Institute Memorandum to Tax Members No. 19-97, dated June 13, 1997. 2 Included in the attachments are the bill's relevant statutory language (labeled "A") and accompanying explanatory language (labeled "B"). June 13, 1997 TO: PENSION MEMBERS No. 23-97 TAX MEMBERS No. 20-97 OPERATIONS COMMITTEE No. 17-97 TRANSFER AGENT ADVISORY COMMITTEE No. 26-97 PENSION OPERATIONS ADVISORY COMMITTEE No. 17-97 RE: HOUSE WAYS AND MEANS COMMITTEE PENSION LEGISLATION ______________________________________________________________________________ The House Ways and Means Committee today approved the "Revenue Reconciliation Act of 1997," which will now be offered for full consideration by the full House. This memorandum summarizes the pension-related provisions in the Committee's bill. A separate memorandum summarizes additional tax provisions in the bill of relevance to registered investment companies ("RICs") and their shareholders.1 The Senate Finance Committee is expected to consider similar legislation during the week of June 16. A. American Dream IRA Proposal (Attachments 1A and 1B)2 The bill would replace present-law nondeductible IRAs with a new IRA vehicle, the "American Dream IRA." The "AD IRA" is a back-loaded Individual Retirement Account, similar to that which has been proposed in previous years. All individuals, without any limitations based on income or pension plan participation, would be able to make non-deductible contributions to an AD IRA account. Earnings would accrue tax-free in the account and, upon the satisfaction of specified criteria, distributions (both basis and earnings) would not be includible in gross income. The bill would permit the establishment of AD IRAs in tax years beginning after December 31, 1997 and repeal present Code provisions permitting nondeductible IRA contributions for tax years beginning after December 31, 1997. The bill permits an individual to contribute up to $2,000 annually to an AD IRA, in addition to any contributions made to a deductible IRA. (In other words, unlike some earlier forms of this proposal, individuals would not be required to offset their AD IRA contributions against an aggregate deductible/AD IRA limit.) As under present law for deductible IRAs, an additional contribution of up to $2,000 could be made to an AD IRA for a spouse. The AD IRA's $2,000 contribution limit would be adjusted annually for inflation in $50 increments. Additionally, the bill permits individuals to rollover assets from a deductible IRA account to an AD IRA if such rollovers are made prior to January 1, 1999. 3 Please note, the $5,000 limitation was added by amendment and is not in the published bill language. A copy of the amendment language is attached. 4 Last year's Small Business Job Protection Act added Code section 529 to clarify that qualified State tuition programs are exempt from federal income taxation. Under such programs a person either may purchase tuition credits on behalf of a designated beneficiary, which may be used by the beneficiary in payment of "qualified higher education expenses," or may make contributions to an account established solely to pay for such expenses of the beneficiary. This bill makes

numerous amendments to section 529. - 2 - Amounts required to be included in gross income by reason of the rollover may be spread ratably over four years. “Qualified distributions” from an AD IRA are not includible in income. A qualified distribution is one that is (1) made after the satisfaction of a five-year holding period beginning with the first year in which the individual or the individual’s spouse made a contribution to an AD IRA and (2) which is (i) made on or after the individual attains age 59 1/2, (ii) made on or after the individual’s death, (iii) attributable to the individual’s being disabled, or (iv) a qualified first-time homebuyer distribution, as further defined in the bill. Nonqualified distributions are subject to Section 72 taxation rules and, therefore, are includible in income to the extent attributable to earnings and are subject to the 10-percent early withdrawal tax, unless an exception applies. Such exceptions would include an exception for amounts withdrawn from the AD IRA to pay for first-time homebuyer expenses. Distributions from an AD IRA are treated as being made from contributions to the AD IRA first (rather than from earnings). Premature withdrawals attributed to contributions are not includible in income. For purposes of this ordering rule, all AD IRA accounts are aggregated and treated as one account. Finally, the bill provides that distributions from an AD IRA need not be taken into account for purposes of the Code Section 4980A excise tax on excess distributions or the additional estate tax on excess accumulations. B. Education Investment Accounts (Attachments 2A and 2B) The bill provides for the establishment of “Education Investment Accounts” (EIAs). Individuals would be permitted to establish an EIA for the benefit of an account holder under the age of 18 in the form of a trust or custodial account. The exclusive purpose of the account must be to fund the “qualified higher education expenses” of the account holder. Individuals may make contributions in amounts up to $5,0003 annually to an EIA per beneficiary until the account holder, that is, the EIA beneficiary, attains age 18. Additionally, contributions to an EIA are limited by a lifetime, aggregate contribution limit of $50,000 to all EIAs established for the benefit of any one individual. Furthermore, the $50,000 limitation is reduced to the extent that contributions have been made on behalf of that individual to a section 529 qualified tuition program.4 Excess contributions would be taxed under Code section 4973. The bill, however, would permit the return of excess contributions before the due date of the contributor’s tax return. Contributions to an EIA are treated as a gift from the contributor to the account holder at the time of the contribution and are eligible for the $10,000 gift tax exclusion. Distributions from an EIA are intended to be used to pay for qualified higher education expenses. Distributions would be includible in gross income in the same manner as amounts 5 Such deductions would not be permitted with respect to a student after the student completes the equivalent of four years of post-secondary education. 6 Where the student is claimed as a dependent, only the taxpayer claiming the student, not the student, may claim this deduction. Under the bill, for each taxable year a taxpayer may elect with respect to an eligible student either a "HOPE" credit (which is only available to taxpayers meeting certain income-based eligibility criteria) or the proposed $10,000 deduction for qualified higher education expenses. Discussion of the HOPE tax credit program, which is also proposed in this bill, is beyond the scope of this memorandum. - 3 - distributed from a qualified tuition program under section 529(c). Generally, amounts distributed from the EIA would be includible in the gross income of the distributee (or the individual taxpayer claiming the distributee as a dependent) in the same manner as provided under present-law Code section 72. Taxpayers may take an offsetting deduction for distributions includible in income. To the extent a taxpayer is required to include in income distributions from an EIA or a “qualified tuition program,” such amounts would be deductible in amounts up to $10,000 annually per student (up to an aggregate, lifetime deduction of $40,000 for any one student) where the distributions are used to pay for qualified higher education expenses.5 For example, if a student is the beneficiary of an EIA with a balance of $20,000, a parent filing federal income taxes and claiming the student as a dependent could withdraw $10,000 from the EIA, use that amount to pay qualified higher education expenses, include in gross income the pro rata portion of the $10,000 attributable to accumulated earnings, and then claim an offsetting deduction for that earnings amount. The principal portion of the distribution from the EIA would not be includible in gross income nor would a deduction be permitted for it.6 Any balance remaining in an EIA must be distributed within 30 days after the earlier of the date upon which the account holder becomes 30 years old, dies or completes the equivalent of the first four years of post-secondary education. The bill also provides, however, that account balances may be transferred from one EIA to an EIA benefiting a different individual so long as that person is a family member. Finally, an additional 10-percent tax is imposed on any distribution from an EIA that is not either used to pay qualified higher education expenses or distributed on account of death, disability or scholarship received by the account holder. The trustee or custodian of an EIA must be a bank (as defined in Code section 408(n)) or a similar entity or person. The trustee or custodian of the EIA would be required to make reports to the IRS and account holder with respect to contributions and distributions. C. Penalty-Free Withdrawals For All IRAs For Higher Education (Attachments 3A and 3B) The bill provides that the 10-percent early withdrawal tax penalty would not apply to distributions from IRAs, including AD IRAs, if the taxpayer uses the amounts to pay qualified higher education expenses of the taxpayer, the taxpayer's spouse, or any child or grandchild of the taxpayer or taxpayer's spouse. This provision would apply to distributions from IRAs made after December 31, 1997 with respect to expenses paid after that date for education furnished in academic periods beginning after that date. D. SIMPLE Plan Clarification (Attachments 4A and 4B) The bill also contains technical corrections pertaining to the Small Business Job Protection Act of 1996 and SIMPLE plans that would: - 4 - (1) clarify that SARSEPs established on or before December 31, 1996 may permit new employees hired after that date to participate in the SARSEP; (2) clarify that the maximum annual dollar limitation applicable to a SIMPLE IRA is the limitation applicable for contributions made under Code section 408(p), not the $2,000 limit for traditional IRAs; (3) clarify that insurers offering annuities for SIMPLE IRAs have the same reporting requirements as SIMPLE IRA trustees; (4) conform the time for providing reports for SIMPLE IRAs to that for IRA reports generally by providing that the report required to be furnished to the individual under a SIMPLE IRA would be provided within 31 days after each calendar year; (5) clarify that an employer who maintains a qualified plan for collectively bargained employees is permitted to maintain a SIMPLE IRA plan for noncollectively bargained employees; (6) provide that if an employer who maintains a qualified plan and a SIMPLE IRA plan in the same year due to a corporate acquisition, the SIMPLE IRA plan will be treated as a qualified salary reduction arrangement for the year of the transaction and the following calendar year; (7) provide that the $6,000 limit on elective deferrals under a SIMPLE 401(k) plan will be adjusted for inflation at the same time and in the same manner as for SIMPLE IRAs; (8) clarify that the top-heavy rules do not apply to SIMPLE 401(k) plans; (9) clarify that to the extent contributions paid by an employer to a SIMPLE 401(k) arrangement satisfy the contribution requirement of section 401(k)(11)(B), the contributions will be treated as deductible by the employer; and (10) clarify that identical employer notice and employee election requirements apply to both SIMPLE IRA and SIMPLE 401(k) plans. E. Other Miscellaneous Pension Reform Proposals (Attachments 5A and 5B) The revenue reconciliation bill also includes provisions that would: (1) make section 401(k) plans available to certain water districts organized as municipal corporations; (2) make permanent the Internal Revenue Service's moratorium on the application of nondiscrimination rules for governmental plans; (3) modify the manner in which defined benefit plan contribution limitations apply to State and local governmental plans; (4) modify the $1,000 filing threshold for an IRA with unrelated business income derived from certain investment in partnerships; - 5 - (5) provide for a waiver of the Code section 6652(g) penalty for failure to make a report required by section 219(f)(4) in connection with deductible employee contributions if reasonable cause for the failure is established; and (6) 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). We will keep you informed of developments. Russell G. Galer Assistant Counsel - Pension Kathryn A. Ricard Assistant Counsel - Pension Attachment (in .pdf 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)326-8304, and ask for this memo's attachment number: 8987].

---