

MEMO# 17042

February 4, 2004

PRESIDENT'S 2005 BUDGET INCLUDES SAVINGS AND RETIREMENT INITIATIVES

[17042] February 4, 2004 TO: 529 PLAN ADVISORY COMMITTEE No. 4-04 OPERATIONS MEMBERS No. 7-04 PENSION MEMBERS No. 7-04 PENSION OPERATIONS ADVISORY COMMITTEE No. 9-04 TAX MEMBERS No. 7-04 TRANSFER AGENT ADVISORY COMMITTEE No. 15-04 RE: PRESIDENT'S 2005 BUDGET INCLUDES SAVINGS AND RETIREMENT INITIATIVES

The President's Budget for fiscal year 2005 includes several savings and retirement initiatives, including Retirement Savings Accounts ("RSAs"), Lifetime Savings Accounts ("LSAs"), Employer Retirement Savings Accounts ("ERSAs") and Individual Development Accounts ("IDAs"). These proposals are similar in many respects to proposals included in the President's budget for fiscal year 2004.¹ One of the biggest changes from last year's proposals is a reduction in the contribution limits for RSAs and LSAs from \$7,500 to \$5,000. This year's proposal also adds the IDA, a savings vehicle with a tax-credit matching feature intended to encourage savings among lower income individuals.

A. RSAs The President's RSA proposal is essentially the same as last year's proposal, except that last year's contribution limit of \$7,500 is reduced to \$5,000 (indexed for inflation). This account would not impose age or income limitations, except that contributions cannot exceed compensation. Like Roth IRAs, contributions to RSAs would be nondeductible, account earnings would accumulate tax-free and qualified distributions would be excluded from gross income. The President's proposals regarding RSAs would become effective beginning on January 1, 2005.

1 See Institute Memorandum to 529 Plan Advisory Committee No. 7-03, Operations Members No. 4-03, Pension Members No. 7-03, Tax Members No. 7-03 and Transfer Agent Advisory Committee No. 13-03 (15601), dated January 31, 2003. Attached are relevant excerpts from the President's FY 2005 budget. The Treasury Department's press release at <http://www.treas.gov/press/releases/js1131.htm> provides additional information regarding these proposals.

2 1. Special Rules for RSAs Qualified distributions from RSAs could be made after age 58 or in the event of death or disability. Nonqualified distributions in excess of prior contributions would be included in income and subject to additional tax. Married individuals could roll amounts from their RSAs to their spouse's RSAs. Additionally, the saver's credit would apply to RSA contributions.

2. Conversions to RSAs The President's proposal would rename Roth IRAs to RSAs and subject them to the new RSA rules. Existing traditional and nondeductible IRAs could be converted to RSAs in a manner similar to current Roth IRA conversions - by taking the conversion amount into gross income. Conversions would not be subject to income limitations and would not be mandatory. Taxpayers who convert their IRAs to RSAs prior to January 1, 2006 could include the conversion amount in income ratably over four years. Conversions made on or after January 1, 2006 would be included in income in the year of conversion. Existing traditional and nondeductible IRAs that are not converted to RSAs could not accept any new contributions after 2004. New traditional IRAs also could be created to accept rollover

contributions from employer plans, but these accounts could not accept any new contributions. Additionally, individuals could roll over amounts from an employer plan directly into an RSA by first taking the rollover amount into income. Amounts converted to an RSA from a traditional IRA or from an ERSA would be subject to a five-year holding period starting with the year of the conversion. Distributions attributable to either a traditional IRA or ERSA and made prior to the end of the five-year holding period would be subject to an additional 10 percent early distribution tax on the entire amount of the distribution.

B. LSAs The President's LSA proposal is essentially the same as last year's proposal, except that last year's contribution limit of \$7,500 is reduced to \$5,000 (indexed for inflation). This account would not impose age or income limitations. Like Roth IRAs, contributions to LSAs would be nondeductible, account earnings would accumulate tax-free and qualified distributions would be excluded from gross income. The President's proposals regarding LSAs would become effective beginning on January 1, 2005.

1. Special Rules for LSAs With respect to LSAs, no minimum required distribution rules would apply to the account owner at any time. The \$5,000 contribution limit applies to the individual account owner and not the contributor. Thus, contributors could make annual contributions to the accounts of other individuals, provided, however, that annual aggregate contributions to an individual's account do not exceed \$5,000. Control over an account in a minor's name would be exercised exclusively for the minor's benefit by the minor's parent or legal guardian until the minor reached the age of majority (as determined by state law). Married individuals could roll amounts from their LSAs to their spouse's LSAs.

3 2. Conversions to LSAs The President's proposal permits conversion of balances in Coverdell Education Savings Accounts ("ESAs") or 529 Plans into LSAs. All conversions must be made before January 1, 2006, subject to certain limitations. The amount that may be rolled over to an LSA from a 529 Plan is limited to the sum of (1) the lesser of \$50,000 or the amount in the 529 Plan as of December 31, 2003 and (2) any contributions and earnings to the 529 plan in 2004. Total rollovers to an individual's LSA attributable to 2004 ESA and 529 Plan contributions, however, cannot exceed \$5,000 plus earnings on those contributions. Individuals could also choose to continue to contribute to ESAs and 529 Plans as under current law, and these education accounts could be offered inside an LSA. For example, states could offer LSAs with the same investment options available under the state's 529 plan. Such an LSA would not be subject to the 529 Plan's reporting requirements, but investors would be subject to the annual LSA contribution limit. Distributions for purposes other than education would not be subject to federal income tax or penalties. States could, however, offer state tax and other incentives for using such LSA funds exclusively for education. Health Savings Accounts ("HSAs") and Archer Medical Savings Accounts ("MSAs") would also be retained as under current law.

C. ERSAs The President's ERSA proposal would consolidate 401(k) plans, SIMPLE 401(k) plans, 403(b) plans, governmental 457 plans, SARSEPS and SIMPLE IRAs into one retirement plan.

2 The ERSA would be available to all employers and would be subject to simplified administrative rules that generally follow the rules applicable to 401(k) plans. Employees could defer wages of up to \$13,000 annually (increasing to \$15,000 by 2006), with employees aged 50 and older able to defer an additional \$3,000 per year (increasing to \$5,000 by 2006). The maximum total contribution (including employer contributions) to ERSAs would be the lesser of 100 percent of compensation or \$41,000. ERSA contributions could include pre-tax deferrals, after-tax employee contributions or Roth-type contributions, depending on the design of the plan. Distributions of Roth-type and non-Roth after-tax employee contributions would be excluded from income. All other distributions would be included in income. This proposal would become effective for years beginning after December 31, 2004.

1. ERSA Discrimination Testing A single nondiscrimination test would apply to ERSA contributions: the average contribution percentage (the sum of all employee and employer contributions

divided by the employee's compensation) of highly compensated employees ("HCEs") could not exceed 200% of non-highly compensated employees' ("NHCEs") percentage if the NHCEs' average contribution percentage is six percent or less. No discrimination testing is applied if the average contribution percentage of NHCEs exceeds six percent. Additionally, employers could avoid 2 Rules applicable to defined benefit plans would not be affected by the ERSA proposal. 4 discrimination testing by implementing a design-based safe harbor such that all eligible NHCEs receive fully vested employer contributions equal to at least three percent of compensation. ERSAs sponsored by state and local governments would not be subject to nondiscrimination testing at all under certain circumstances. Employers with 10 or fewer employees making \$5,000 could choose to offer a custodial ERSA, which would be exempt from annual reporting requirements and most ERISA fiduciary rules, similar to the relief currently provided to the SIMPLE IRA. The employer's contributions to the custodial plan must satisfy the three-percent design-based safe harbor described above. 2. ERSA Conversions Existing 401(k) and thrift plans would be renamed ERSAs and could continue to operate as under current law, subject to the simplified ERSA rules. Existing SIMPLE 401(k) plans, SIMPLE IRAs, SARSEPs, 403(b) plans and governmental 457 plans could be renamed ERSAs and become subject to the ERSA rules; or these plans could continue to exist separately but could not accept new contributions after December 31, 2005. Special transition rules would apply to collectively bargained plans and plans sponsored by state and local governments. D. IDAs The President's budget for fiscal year 2005 expands the attractiveness of IDAs, a savings vehicle designed to encourage savings among lower income individuals. IDAs are accounts that would provide dollar-for-dollar matching contributions up to \$500 for single filers with incomes below \$20,000, joint filers with incomes below \$40,000 and head of household filers with incomes below \$30,000. Individuals between the ages of 18 and 60 who are not dependents or students would be eligible to establish an IDA. Matching contributions would be supported by a 100% tax credit given to sponsoring financial institutions that provide savings matches to account holders. The proposal also includes a \$50 per account credit for financial institutions to cover the costs of maintaining, administering and providing financial education with respect to IDAs. Contributions to IDAs would be non-deductible and earnings would be taxable to the account holder. Qualified withdrawals of contributions and matching funds would be permitted for higher education, first-time home purchases and business capitalization. Nonqualified withdrawals of matching funds are not permitted and nonqualified withdrawals of participant contributions could result in forfeiture of matched funds. The credit would apply with respect to the first 900,000 IDA accounts opened before January 1, 2010 and with respect to matching funds made after December 31, 2004 and before January 1, 2012. The credit could generally be claimed for taxable years ending after December 31, 2004 and beginning before January 1, 2012. Lisa Robinson Assistant Counsel Attachment 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 17042, or call the ICI Library at (202) 326-8304 and request the attachment for memo 17042. 5 Attachment (in .pdf format)