

**MEMO# 3481**

January 30, 1992

## **ADMINISTRATION'S TAX PROPOSALS**

January 30, 1992 TO: BOARD OF GOVERNORS NO. 8-92 TAX COMMITTEE NO. 3-92 ACCOUNTING/TREASURERS COMMITTEE NO. 6-92 PENSION COMMITTEE NO. 8-92 OPERATIONS COMMITTEE NO. 3-92 CLOSED-END FUND COMMITTEE NO. 2-92 UNIT INVESTMENT TRUST COMMITTEE NO. 7-92 RE: ADMINISTRATION'S TAX PROPOSALS

The Administration has included several tax proposals significant to the investment company industry in its Fiscal Year 1993 budget. This memorandum describes the proposals and attaches relevant portions of the Treasury Department's General Explanation of Proposals.

I. Capital Gains Tax Rate Reduction The Administration's capital gains tax proposal would permit individuals (but not corporations) to exclude from income, effective February 1, 1992, a percentage of capital gain realized upon the disposition of certain capital assets (such as securities) that would vary based upon the length of time the assets were held. This "sliding-scale" or "tiered" capital gains exclusion would be 45 percent for assets held for more than three years, 30 percent for assets held for more than two years and 15 percent for assets held for more than one year. Special transition rules would phase in these new holding period requirements during 1992 and 1993.

II. Flexible Individual Retirement Accounts The Administration's proposal would add to the Internal Revenue Code a new provision for the establishment of flexible individual retirement accounts ("FIRAs"). Married couples with income of \$120,000 or less could make FIRA contributions of up to \$5,000 per year (\$2,500 to each of two FIRA accounts). Single taxpayers with income of \$60,000 or less could contribute up to \$2,500 to a FIRA. Eligible FIRA investments would be the same as for current individual retirement accounts ("IRAs").

- 2 - Contributions to FIRAs would not be deductible, but both the contributions and earnings thereon could be withdrawn tax-free if the contribution remained in the FIRA for at least seven years. If amounts were withdrawn prior to the expiration of seven years from the date of the contribution to which they were applicable, the earnings would be taxable as ordinary income in the year of the withdrawal. Earnings attributable to contributions held for less than three years would be subject to an additional 10 percent excise tax. Amounts in existing IRAs (other than IRAs including rollovers from qualified pension or profit sharing plans) could be converted to a FIRA if the conversion is made between February 1, 1992 and December 31, 1992. These amounts would be included in income ratably over a four-year period.

III. Withdrawals from IRAs for Medical and Educational Expenses and for First Time Home Purchases The Administration's proposal also would permit IRA owners to make certain withdrawals from an IRA on or after February 1, 1992 on a penalty-free basis. No penalty would be imposed on any IRA withdrawal for medical expenses of the IRA owner, the owner's spouse and the owner's dependents. In addition, penalty-free withdrawals could be made for higher education and post-secondary vocational education expenses of the IRA owner, the owner's spouse and the owner's children. No limit would be imposed on the amount of the withdrawals for qualifying medical or educational expenses. Individuals could also withdraw up to \$10,000

from their IRAs on a penalty-free basis for first time home purchases. IV. Pension Simplification A. Small Business Model Retirement Plan The Administration proposal would "generally replace" the Salary Reduction Simplified Employee Plan ("SARSEP") with a Small Business Model Retirement Plan. Availability of this new plan would be limited to businesses that normally employ less than 100 persons throughout the year and that have no other pension plans. Sponsoring employers generally would be required to contribute one percent of pay for each employee. Employees could contribute up to \$3,000 per year on a salary deferral basis and employers would be required to make matching contributions equal to the first 3 percent of compensation that an employee elects to defer plus 50 percent of the employee's elective deferrals that represent between 3 and 5 percent. B. Other Pension Simplification Proposals The Administration's proposal would also amend the section 401(k) nondiscrimination rules to allow testing for each plan - 3 - year on the basis of the non-highly compensated employee - 4 - deferrals for the previous plan year. In addition, most of the current restrictions on the types of pre-retirement distributions eligible for IRA rollover treatment would be eliminated and plans would be required to give employees the option of having distributions transferred directly to an IRA or another qualified plan. Further, the proposal would make section 401(k) plans available to tax-exempt employers. Finally, the proposal would require the IRS to define the duties of sponsors of master and prototype and other model plans, especially with respect to insuring that adequate administrative services (including timely amendments) are provided with respect to the plan. We will keep you informed of developments. Keith D. Lawson Associate Counsel - Tax Attachment KDL:bmb