MEMO# 9110

August 1, 1997

CONGRESS SENDS PRESIDENT TAX BILL REPEALING 30-PERCENT LIMIT AND EXPANDING IRAS

August 1, 1997 TO: BOARD OF GOVERNORS No. 47-97 FEDERAL LEGISLATION MEMBERS No. 12-97 PRIMARY CONTACTS - MEMBER COMPLEX No. 49-97 PUBLIC INFORMATION COMMITTEE No. 23-97 RE: CONGRESS SENDS PRESIDENT TAX BILL REPEALING 30-PERCENT LIMIT AND EXPANDING IRAs

____ Via Facsimile and U.S. Mail I am pleased to report than on July 31, the House (by vote of 389 to 43) and the Senate (by a vote of 92 to 8) approved the "Taxpayer Relief Act of 1997." The bill will now be sent to President Clinton for his signature. This legislation contains a number of provisions of interest to the investment company industry and its shareholders, including provisions that would repeal the 30-percent test for regulated investment companies and expand IRAs. Specifically, the bill includes the following provisions: 30-percent limitation ("short-short" rule) The 30-percent limitation on the sale or disposition of securities held for less than three months by regulated investment companies would be repealed, effective for taxable years beginning after the date the President signs the bill. IRA expansion: new nondeductible accounts New nondeductible IRAs called "Roth IRA accounts" would be established with income eligibility limits of $95,000 for individuals and $150,000 for couples. (The present-law nondeductible IRA would be retained for persons not eligible for Roth IRA accounts.) Contributions to a Roth IRA would be nondeductible. However, withdrawals from the account would not be included as income or subject to a 10-percent early withdrawal tax if the individual has established an account that is at least five years old and withdrawals are either: 1) made after the individual attained 59½, became disabled, or died; or 2) made for a first-time home purchase. Withdrawals for higher education expenses would not be subject to the 10-percent penalty, and the expenses could be deducted from income under another provision in the bill. For all other withdrawals, earnings on contributions would be taxable, and the withdrawal would be subject to a 10-percent early withdrawal tax. A rollover from a current deductible or nondeductible IRA into a Roth IRA would only be permitted if the taxpayer's income is less than $100,000. 2 Increased eligibility for deductible IRAs Current income limits for deductible IRA eligibility would double over the next ten years. For individuals, the limit would increase incrementally from the current level of $25,000 to $50,000 in 2005. For couples, the limit would increase incrementally from the current level of $40,000 to $80,000 in 2007. Penalty-free IRA withdrawals Penalty-free withdrawals from all IRAs would be provided for first-time home purchases and for higher education expenses. Spousal IRA An individual's eligibility to contribute to a deductible IRA would no longer be affected by the spouse's coverage under an employer pension plan, if the couple's income does not exceed $150,000. Education IRA An Education IRA could be established for a child under age 18, with annual nondeductible contributions limited to $500 per child; contributions of $500 could only be made by individuals with income below $95,000 or couples with income below $150,000. Capital gains The maximum capital gain tax rate for individuals would be reduced from 28 percent to 20 percent (or to 10 percent for persons in the 15-percent income tax bracket). This reduction would be effective May 7, 1997 for assets held at least 18 months, or for assets held at least 12 months and disposed of between May 7 and July 29, 1997. For assets held from 12 to 18 months, the maximum rate would be 28 percent, as under present law. For assets acquired after 2000 and held for at least five years, the maximum rate would be 18 percent (or 8 percent for persons taxed at a 15 percent rate). There is no capital gains indexing provision. Pension simplification The tax bill contains a number of pension simplification provisions, including ones that would: 1) repeal the 15-percent excise tax on excess distributions from qualified retirement plans, tax-sheltered annuities, and IRAs; 2) repeal the 15-percent estate tax on excess retirement accumulations; 3) rationalize the 401(k) and SIMPLE plan contribution schedules to subject both the employees and the employers/partners to the same $9,500 elective contribution limit, regardless of amounts of employer matching contributions (under current law, the $9,500 contribution limit for employers/partners applies to both matching and elective contributions); 4) allow employers to cash out pension benefits of terminating employeeswithout the employee’s consentwhere the benefits have present value of less than $5,000 (rather than $3,500, as under present law); and 5) remove existing ERISA requirements for employers without qualified retirement plans and who establish payroll deduction plans for employee IRAs. (The Senate bill provision that would have required spousal consent for 401(k) plan lump- sum distributions is not included in the tax bill sent to the President.) Simplified foreign tax credit Mutual fund shareholders generally would no longer be required to fill out a special form to accompany their tax returns in order to take the foreign tax credit. Passive Foreign Investment Companies (PFICs) Mutual funds and other investors would generally be able to elect mark-to-market treatment for their PFIC shares; by 3including unrealized PFIC gains in their income annually, investors could avoid the anti- deferral penalties under present law. President Clinton has indicated that he will sign the bill approved by the Congress. The passage of this legislation culminates a decade-long effort by the Institute to secure many of these provisionsimportantly, the repeal of the 30-percent test and expansion of savings opportunities for fund shareholders. I would like to thank the many Institute members who contributed to this successful effort. Matthew P. Fink President

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