

MEMO# 9635

February 6, 1998

ADMINISTRATION DESCRIBES PENSION PROPOSALS IN PRESIDENT'S BUDGET

1 See Institute Memorandum to Pension Members No. 7-98, dated January 29, 1998. [9635]
February 6, 1998 TO: PENSION COMMITTEE No. 3-98 RE: ADMINISTRATION DESCRIBES
PENSION PROPOSALS IN PRESIDENT'S BUDGET

As you were previously informed,¹ the Clinton Administration has included pension reform as part of its 1998 budget proposal. Attached are descriptions of pension reform proposals from the Department of Treasury's "General Explanations of the Administration's Revenue Proposals." The proposals include the following items: (1) Payroll Deduction IRAs. The President proposes to facilitate the availability of payroll deduction IRA programs, by permitting contributions to an IRA made through payroll deduction to be excluded from income and, thus, not be reported as income on an employee's W-2. The amounts would continue to be subject to employment taxes and would be reported as a contribution to an IRA on the employee's Form W-2. (2) Start-up Tax Credit. The President proposes to induce small employers who currently do not offer a retirement plan to their employees to do so with a start-up tax credit, which would be available to employers of less than 100 employees if they establish an employer-sponsored retirement plan on or before December 31, 2000. The tax credit would be available for three years and cover 50 percent of the first \$2,000 in administrative and education-related expenses for the plan for the first year and 50 percent of the first \$1,000 of these expenses in each of the second and third years. (3) Simplified Defined Benefit Plan For Small Employers. The President proposes to make available a new simplified small business defined benefit pension plan, called the Secure Money Annuity or Retirement Trust ("SMART") plan. The SMART plan is designed to reduce the need for actuarial calculations typically associated with defined benefit plans. Additionally, such plans would not be subject to nondiscrimination or top-heavy rules or the limitation on benefits under Code section 415. The plan would be available to employers with no more than 100 employees who received at least \$5,000 in compensation in the prior year. It would not be available either to "professional service employers" or employers who had maintained a defined benefit or money purchase plan within the preceding five years. The SMART plan would provide a fully funded minimum defined benefit based on an annual contribution by the employer into individual accounts for each employee. The annual employer contribution would be determined such that each employee would earn a minimum annual benefit at retirement equal to 1 or 2 percent of compensation for that year. (For the first - 2 - five years of the plan's existence, the employer could provide a benefit equal to 3 percent of compensation.) The maximum annual compensation taken into account under the plan, however, would be \$100,000. Each year an employer would contribute an amount sufficient to provide the annual benefit accrued for that year payable at age 65, using actuarial assumptions specified in the statute, including a 5 percent annual

interest rate assumption. In years in which a participant's account balance is less than the total past employer contributions credited with 5 percent interest per year, the employer would be required to make up the shortfall with an additional contribution. Similarly, each account balance must be sufficiently funded on an annual basis to purchase a life annuity paying the minimum guaranteed benefit at retirement; the employer would be responsible for this shortfall. On the other hand, where investment return exceeds the 5 percent assumption, the employee would be entitled to the excess return, which would increase the value of the benefit produced at retirement. Plan assets would be invested in either individual retirement annuities issued by an insurance company or through a trust, which could invest in readily tradable securities and regulated insurance products. Employees would be immediately 100 percent vested in their benefit. Benefits at retirement would be subject to joint and survivor annuity rules, although the plan could make available a lump sum payment at retirement. Distributions would be permitted only upon attainment of age 65, death, disability, or where the account value of a terminated employee was no more than \$5,000. A 20-percent penalty tax would be imposed on distributions not meeting these criteria. Where held in trust, rather than in individual retirement annuities, the benefits would be guaranteed by the Pension Benefit Guaranty Corporation, to which the employer would have to pay an annual insurance premium. (4) Acceleration of the Vesting Schedule For 401(k) Plan Matches. The President would accelerate vesting of 401(k) plan matching contributions to require an employee be fully vested either at completion of three years of service or based on a six-year graduated schedule. (5) Enhanced Disclosure Regarding Survivor Benefits and 401(k) Salary Deferral Election Opportunities. Employers would be required to provide written explanations of survivor benefits to spouses at the same time as provided to participants. Also, employers electing to use a section 401(k) plan safe harbor design would be required during a 60-day period before the beginning of the plan year to provide notice to participants informing them that they may elect to contribute or modify prior elections to contribute to the plan. This 60-day notice is similar to that required for SIMPLE plans. (6) Modification of 401(k) Plan Safe Harbor Formulas. The design-based 401(k) safe harbor formulas, which eliminate the need to perform annual ADP/ACP testing, would be modified. In addition to current safe harbor contribution formulas under the safe harbors, employers would be required to make an additional one percent of compensation contribution for each eligible, nonhighly compensated employee. (7) Revision of "Highly Compensated Employee" Definition. The definition of "Highly Compensated Employee," which is used in applying nondiscrimination tests, was simplified in the Small Business Job Protection Act of 1996. The President proposes to eliminate the optional election to use a "top 20 percent of employees" test when defining the "HCE" group. - 3 - (8) Reforms Relating to Tax Treatment of Variable Annuities. Also included in the budget are proposals that would modify the tax treatment of insurance contracts. Proposals would (1) tax exchanges of insurance contracts with variable contracts, (2) treat each variable contract investment in a separate account mutual fund or in an insurance company's general account as a separate contract, (3) reduce the "investment in the contract" amount for mortality and expense charges on insurance contracts by modifying the manner in which basis is computed under Code section 72, and (4) modify rules applied to corporate-owned life insurance (COLI). These items are further described in the attachment. Russell G. Galer Associate Counsel Attachment