SUMMARY OF ADMINISTRATION'S PENSION PROPOSAL "INDIVIDUAL RETIREMENT BENEFITS ACT OF 1971"

PREPARED FOR THE USE OF THE

COMMITTEE ON WAYS AND MEANS

BY THE STAFF OF THE

JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

MAY 8, 1972

U.S. GOVERNMENT PRINTING OFFICE
77-558 WASHINGTON : 1972 JCS-2-72

SUMMARY OF ADMINISTRATION'S PENSION PROPOSAL "INDIVIDUAL RETIREMENT BENEFITS ACT OF 1971"

I. Employer Plans

A. Age and Service Eligibility Requirements

Present law.—The statute does not presently contain any specific eligibility conditions relating to age or service. Current regulations allow plans to be limited to employees who have (1) attained a designated age, or (2) have been employed for a designated number of years, as long as the effect is not discriminatory. Also, under administrative practice, a plan may exclude employees who are within a certain number of years of retirement (e.g., 5 or less) when they would otherwise become eligible.

Administration's proposal.—Provides that a qualified plan could not require (as a condition of participation) any one of the following:

(1) that an employee have service with the employer in excess of 3 years;

(2) that an employee have attained an age in excess of 30 years; or

(3) that an employee who would otherwise become eligible to participate be more than 5 years younger than the earliest age at which he could retire with unreduced benefits.

B. Pre-Retirement Vesting

Present law.—Although a qualified plan must provide that an employee's rights are nonforfeitable upon its termination, or on discontinuance of contributions thereunder, there is no requirement that an employee have a nonforfeitable right to receive his accrued benefits before retirement. (The lack of pre-retirement vesting may, however, be taken into account to determine whether the plan is discriminatory.)

Administration's proposal.—

(1) *Time of vesting.*—Provides that a qualified plan must require that an employee's rights in 50 percent of accrued benefits become nonforfeitable on whichever of the following occurs later—

(a) as of the end of the year in which the sum of his age and years of participation in the plan equals or exceeds 50 ("Rule of 50"), or

(b) after 3 years participation in the plan (reduced by any service before eligible to participation in plan).

(2) *Vesting as to balance of accrued benefit.*—After the occurrence of the event in (1), the employee's rights in the remaining 50 percent of accrued benefits must become nonforfeitable at least ratably over the next 5 years.

(3) *Relief for plans not fully funded.*—Existing plans are relieved of the pre-retirement vesting requirements during a plan year in which—

(a) benefit payments to retired participants exceed benefit accruals; and

(b) the value of accrued liabilities to retired and active participants taken together exceeds the value of plan assets.

This relief is not to apply during any year in which the plan is amended to provide for greater benefits within the next 5-year period.

II. Self-Employed Retirement Plans

A. Age and Service Eligibility Requirements

Present law.—If an owner-employee (i.e., a sole proprietor, or a partner with a greater than 10 percent interest in capital or income) participates, the plan must cover all employees with 3 or more years of service.

Administration's proposal.—A plan in which an owner-employee participates must cover each employee—

(1) who has 3 years or more of service if he is less than 30 years old,

(2) who has 2 years or more of service if he is between 30 and 35 years of age, and

(3) who has one year or more of service if he is 35 years of age or older.

B. Pre-Retirement Vesting

Present law.—A plan in which an owner-employee participates must provide for immediate vesting of benefits for all covered employees (i.e., a nonforfeitable interest in the contributions made on an employee's behalf under the plan).

Administration's proposal.—In a plan in which an owner-employee participates, an employee's interest—

(1) must be nonforfeitable in at least 50 percent of his accrued benefit at the close of the first plan year when the sum of his age and his years of participation in the plan equal 35 ("Rule of 35"), and

(2) must become nonforfeitable in the balance of his accrued benefit under the plan at least ratably over the next 5 years.

C. Contributions

Present law.—

(1) In the case of a self-employed individual—

(a) a deductible contribution made by the employer is limited to the lesser of 10 percent of earned income or $2,500;

(b) an additional $2,500 nondeductible contribution may be made by the self-employed participant in certain circumstances; and

(c) penalties are imposed if excessive contributions are made and are not repaid.

(2) In the case of a shareholder-employee of a subchapter S corporation—

(a) no limit is imposed on the amount that may be contributed on his behalf,

(b) but if the contribution exceeds the lesser of 10 percent of compensation or $2,500, the excess is includible in his gross income.

Administration's proposal.—

(1) The rate at which deductible contributions may be made on behalf of self-employed individuals may not exceed the lowest rate at which contributions are made on behalf of any other participant (but in any event not more than 15 percent of earned income).

(2) The maximum amount of earned income to which the rate may be applied is $50,000 (i.e., this would permit a deduction of as much as $7,500, but only if the owner-employee contributed 15 percent of compensation for his employees and had earned income of at least $50,000).

(3) *Additional nondeductible contributions* made by a self-employed participant may not exceed 10 percent of earned income, again with a maximum of $50,000 of earned income. (Ten percent is the limit under existing administrative practice applicable to nondeductible voluntary contributions by any participant in a qualified plan.)

(4) *Shareholder-employees of subchapter S corporations* are subject to same rules in above paragraphs (1), (2), and (3).

III. Special Eligibility and Pre-Retirement Vesting Requirements for Certain Employer Plans

Present law.—As is the case with employer plans generally, present law provides no special requirements on age and service conditions for participation or for pre-retirement vesting for partnership plans for employees where no owner-employee participates or for plans maintained by closely held corporations (including professional corporations).

Administration's proposal.—The Secretary would be authorized to issue regulations setting forth the circumstances under which plans of the following type would be considered nondiscriminatory—

(1) a plan of a partnership in which no owner-employee (a 10-percent owner) participates and which provides benefits for a partner having (a) more than a 5-percent interest, or (b) an interest between one and 5 percent, if all such employees with interests of this size together own more than 50 percent of the interests, or

(2) a plan of a corporation which provides benefits for a shareholder who owns (a) more than 5 percent of the stock, or (b) between one and 5 percent of the stock, if all such shareholders own (directly or indirectly) more than 50 percent in value of the outstanding stock.

The regulations are to provide that plans of the type referred to above, in order to qualify as nondiscriminatory, must provide for more rapid pre-retirement vesting and earlier age and service conditions for participation than employer plans generally, but such regulations may not require of these plans more rapid pre-retirement vesting of earlier age and service conditions than is required of self-employed retirement plans.

IV. Deduction for Personal Savings Retirement Plans

Present law.—There is no deduction for amounts contributed by an employee to a qualified pension plan (although the income earned on such amounts is not taxed until it is distributed) and no deduction for amounts paid by an individual for his own retirement outside the scope of a qualified plan.

Administration's proposal.—

(1) *The deduction.*—New provisions of the Code would be added allowing a deduction for—

(a) employee contributions to an employer-established plan, or

(b) amounts contributed to an individual's own qualified individual retirement account.

The amount deductible would be limited to 20 percent of the first $7,500 of earned income, or $1,500 maximum.

In the case of a married couple, each spouse would be entitled to claim the deduction, and the limit would be applied separately to each spouse.

(2) *Reduction of deductible amount.*—The maximum deductible amount for an individual would be reduced by—

(a) payments, if any, made by his employer to a qualified pension plan (which the employee, at his option, could assume had been made at a rate of 7 percent of earned income), and

(b) the FICA tax which would have been imposed on any earned income not subject to social security or the railroad retirement system had this income been subject to this tax.

(3) *Definition of a qualified individual retirement account.*—In general, an individual retirement account is qualified if—

(a) it is maintained for the purpose of distributing the contributions and income therefrom to the individual who established the account, his spouse, or his beneficiaries;

(b) no contributions in excess of the maximum deductible amount ($1,500 per year in the case of an individual with $7,500 or more of earned income) are made to the account;

(c) The assets of the account are not commingled with other assets of the individual or his spouse;

(d) a "plan or other governing instrument" provides that (except in the case of death or disability) no distributions will be made from the account until the individual attains the age of 59½ years; and

(e) a "plan or other governing instrument" provides that distributions from the account must begin not later than the time the individual attains the age of 70½ years, and distributions must be large enough so that the entire account will be distributed at least ratably over his life expectancy or the combined life expectancy of the individual and his spouse.

(4) *Management of qualified individual retirement account.*—The account may be held in trust by a bank, credit union or with other trustee, but the individual is not required to establish a trust respect to the account, and the account assets may be held in a custodial account.

The funds of the account may be invested in a broad range of assets including stocks, bonds, bank accounts, and insurance or annuity contracts.

The assets of the account may be transferred from one form of investment to another, or from one trustee to another, but account assets withdrawn from a particular form of investment or trustee must be reinvested within 60 days.

(5) *Taxation of beneficiaries.*—Generally, amounts distributed or made available to a beneficiary of a qualified individual retirement account will be taxable to him in the year in which such benefits are received.

Lump sum distributions from an individual retirement account would not be entitled to capital gains treatment, or to the special averaging treatment provided in section 72(n) of the Internal Revenue Code with respect to certain lump sum distributions under an employer-established qualified pension plan.

Amounts distributed from an individual retirement account before the individual reaches the age of 59½ (except in the case of death or disability) would not be subject to the general averaging provisions contained in subchapter Q of the Code, and would also be subject to an additional penalty tax equal to 30 percent of the amount prematurely withdrawn.

After an individual has reached the age of 70½ years, an excise tax of 10 percent will be imposed annually on amounts retained in the individual retirement account in excess of those amounts necessary so that the account may be distributed ratably over the life expectancy of the individual or the individual and his spouse.

O