[JOINT COMMITTEE PRINT]

DESCRIPTION OF TAX BILLS

(S. 12, S. 24, AND S. 243)

RELATING TO

INCENTIVES TO SAVE FOR RETIREMENT, EDUCATION OR HOUSING

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON SAVINGS, PENSIONS, AND INVESTMENT POLICY

OF THE

COMMITTEE ON FINANCE

ON FEBRUARY 24, 1981

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

FEBRUARY 21, 1981

U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON : 1981

74-160 O JCS-5-81

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INTRODUCTION

This pamphlet provides a description of three Senate bills (S. 12, S. 24, and S. 243) which are scheduled for a public hearing on February 24, 1981, by the Senate Finance Subcommittee on Savings, Pensions, and Investment Policy. The bills relate to the tax treatment of savings accounts of individuals for retirement, education, and housing, and to the partial exclusion of dividends and interest from income.

The first part of the pamphlet is a summary. This is followed by a description of the bills, including a discussion of present law, the issues involved, an explanation of the provisions of the bills, effective dates, and estimated revenue effects.

I. SUMMARY

1. S. 12—Senators Dole, Cochran, and Symms: Certain Employee Retirement Savings Contributions

Under the bill, employees who are active participants in a private qualified pension plan would be allowed to make deductible contributions to the plan, to a group retirement trust or to an individual retirement account. The annual deduction would be limited to the lesser of $1,000 or 15 percent of compensation.

2. S. 24—Senators Dole, Chafee, Danforth, Wallop, Garn, Hatfield, Goldwater, and DeConcini: Deduction of Amounts Deposited in Education and Housing Savings Accounts

Under the bill, individuals would be allowed a deduction of up to $1,000 per year, per beneficiary, for amounts transferred to an education savings account. Distributions from the account for education purposes would be taxed to the beneficiary over a 10-year period, in 10 equal parts, beginning when the beneficiary reaches age 25. The limit on contributions would be indexed for inflation.

A deduction of up to $1,500 ($3,000 in the case of a joint return) per year would be allowed for amounts contributed to a housing savings account. There would be a lifetime maximum deduction of $15,000 ($30,000 in the case of a joint return). The annual contributions and lifetime maximum contributions would be indexed for inflation. The basis of the dwelling would be reduced by the amount distributed for the purchase of the first dwelling of the taxpayer which is to be used as his principal residence.

3. S. 243—Senators Chafee, Warner, and Thurmond: Savings and Retirement Income Income Incentive Act of 1981

a. Sec. 2. Permanent interest and dividend exclusion

Under present law, effective for 1981 and 1982, individuals generally may exclude from gross income up to $200 ($400 in the case of a joint return) of dividends and interest income (Code sec. 116). The bill would make permanent the exclusion for dividends and interest income, and individuals who are 65 or older would be permitted an exclusion of up to $500 ($1,000 in the case of a joint return).

b. Secs. 3-6. Individual retirement accounts and retirement savings deductions

Under the bill, the allowable deduction for a contribution to an individual retirement account would be increased to $2,000 per year. Deductions would be allowed for contributions to a qualified plan in which the taxpayer is a participant or to an individual retirement account (IRA). Benefits generally would be taxable when distributed, except when there is a tax-free rollover into another qualified plan or IRA.

Nondeductible contributions also could be made, subject to a $2,000 annual limit plus an $8,000 lifetime limit. Withdrawals could be made under present rules affecting such plans. In addition, withdrawals could be made from IRAs for educational expenses or for the purchase of a first dwelling of the taxpayer, if it is used as that individual's principal residence.

II. DESCRIPTION OF THE BILLS

1. S. 12—Senators Dole, Cochran, and Symms Certain Employee Retirement Savings Contributions

Present law

An individual generally is entitled to deduct the amount contributed to an individual retirement account or annuity, or used to purchase retirement bonds (referred to collectively as "IRAs"). The limitation on the deduction for a taxable year is generally the lesser of 15% of compensation for the year or $1,500. Under a spousal IRA, the $1,500 contribution limit is increased to $1,750 for a year if (1) the contribution is equally divided between an individual and the spouse of the individual, and (2) the spouse has no compensation for the year. However, no IRA deduction is allowed for a taxable year to an individual who is an active participant during any part of the taxable year in a qualified pension, profit-sharing or stock bonus plan, a tax-sheltered annuity maintained by a tax-exempt organization for an educational institution, or a government plan (whether or not qualified). Except for tax-free rollovers and certain amounts paid for life insurance, nondeductible contributions are not permitted to be made to an IRA. Income and gain on amounts held under an IRA are not taxed until distributed. All distributions from IRAs are includable in gross income. Distributions may be made from an IRA without penalty after age 59½ or in the event of disability or death. Amounts held in an IRA can qualify for exclusions under the estate tax and gift tax rules.

Many qualified plans provide for contributions by both the employer and the employee. In many cases, the employee contributions are mandatory (i.e., required as a condition of employment, a condition of participation in the plan, or a condition of obtaining additional employer-derived benefits). In other cases, employee contributions are voluntary, and the amount, within limits, is left to the discretion of the employee. A plan can provide for both mandatory and voluntary employee contributions. In any case, neither employer nor employee contributions to a qualified retirement plan may discriminate in favor of employees who are officers, shareholders, or highly compensated. Generally, in the case of voluntary employee contributions within certain limits, there is presumed to be no discrimination so long as there is an equal opportunity for all employees to make such contributions. Income allocable to an employee's contributions to a qualified plan is generally not taxed to the plan or to the employee before the income is distributed or made available to the employee or the employee's beneficiary. However, the employee is not entitled to a deduction or exclusion for employee contributions to the plan. Benefits held in a qualified plan can qualify for exclusions under the estate tax and gift tax rules to the extent the benefits are not attributable to employee contributions.

In the case of tax-sheltered annuities (including custodial accounts investing in shares of a regulated investment company) purchased by certain tax-exempt institutions for their employees or purchased by schools for teachers, employees are entitled to an exclusion, within limits, from gross income for amounts paid by the employer on a salary reduction basis. Amounts invested in a tax sheltered annuity purchased by a tax-exempt organization can qualify for exclusions under the estate tax and gift tax rules.

Issue

The issue is (1) whether the present tax incentives for individual retirement savings should be expanded and (2) what safeguards are appropriate.

Explanation of the bill

In the case of an employee who is an active participant in a private qualified plan, a deduction would be allowed for contributions by the employee to the plan, to a group retirement trust,[1] or to an IRA. The annual deduction is limited to the lesser of $1,000 or 15 percent of compensation includible in gross income and is first assigned to any employee contributions to a plan.

Under the bill, benefits attributable to deductible employee contributions to a qualified plan would be taxed under the same rules that apply to benefits attributable to employer contributions. Accordingly, these benefits generally would be taxed only when distributed or made available to the employee or a beneficiary unless rolled over, tax free, to another qualified plan or to an IRA. Such benefits could also qualify for exclusion under the estate and gift tax provisions.

Deductible employee contributions to a plan would be treated as employee contributions, however, in testing whether the plan meets the requirements for tax-qualified status and whether the plan meets the requirements of ERISA.

The bill provides for reports to be filed with the Secretary of the Treasury with respect to deductible employee contributions received by plans.

Effective date

The provisions of this bill would apply to taxable years beginning after the date of enactment.

Revenue effect

It is estimated that this bill will decrease budget receipts by $948 million in fiscal year 1982, $2,066 million in 1983, $2,400 million in 1984 and $2,728 million in 1985.

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[1] Under the bill, a trust is a group retirement trust if (1) it was established before January 1, 1974, (2) it is maintained by a tax-exempt labor organization described in section 501(c)(5), (3) it is financed exclusively by assessments of members of the organization, and (4) the right of any participant in the trust to assessments paid to the trust is fully nonforfeitable.

2. S. 24—Senators Dole, Chafee, Danforth, Garn, Hatfield, Wallop, Goldwater, and DeConcini Deduction of Amounts Deposited in Education and Savings Accounts

Present law

Education expenses

Under present law, there is no general provision which permits deductions for amounts contributed to a trust to pay education expenses of the taxpayer or a child of the taxpayer. However, educational expenses which qualify as trade or business expenses under section 162 may be deducted. In addition, an employer may provide educational assistance to employees as a tax-free fringe benefit under an educational assistance program (sec. 127). Expenditures made by an individual for his own education generally are deductible if they are for education which (1) maintains or improves skills required by the individual's employment or other trade or business, or (2) meets the express requirements of the individual's employer or the requirements of applicable law or regulations imposed as a condition to the retention by the individual of an established employment relationship, status, or rate of compensation. These types of education are commonly called "job-related education."

A taxpayer is permitted to claim an exemption for a child over age 18 who is a full-time student, even though the child may claim a personal exemption on his own return (Code sec. 151).

Housing expenses

There is no general provision which permits deductions for amounts contributed to a savings account to be used for the acquisition of a personal residence of the contributor. However, present law does permit deductions for interest and real property taxes paid by the taxpayer relating to the taxpayer's personal residence (Code secs. 163 and 164). In addition, present law permits the limited use of tax-exempt bonds to finance the acquisition of a principal residence by a first-time homebuyer subject to certain purchase price limitations (Code sec. 103A).

Present law also permits a one time exclusion for taxpayers who are age 55 or older of up to $100,000 of gain derived from the sale of the taxpayer's principal residence (Code sec. 121). In order to qualify for the exclusion, the taxpayer generally must have owned and occupied the residence as the taxpayer's principal residence for a period aggregating 3 out of the 5 years which precede the sale.

Issues

The bill raises the issues of (1) whether education and housing expenditures should be specifically encouraged through tax deductible contributions to special saving accounts for these purposes, and (2) what safeguards are appropriate.

Explanation of the bill

The bill would provide tax incentives for amounts saved for the vocational or higher education of the taxpayer and his children and for amounts saved for the purchase of a dwelling by a first-time homebuyer.

Education savings account

In general.—The bill generally would allow a deduction to individuals of up to $1,000 per year, per beneficiary, for amounts transferred to an education savings account. The account generally would be tax-exempt. Amounts distributed out of the account for education expenses would be taxed to the beneficiary of the account ratably over a 10-year period beginning in the year the beneficiary reaches age 25.

Deduction allowed.—An individual would be allowed a deduction for contributions of cash and the fair market value at the time of transfer of stocks, bonds, or other readily tradeable securities to an education savings account. The deduction would be allowed whether or not the individual itemizes deductions.

Limitation on maximum deduction.—The maximum amount allowed as a deduction for transfers to an education savings account for any one beneficiary would be $1,000 per year. The $1,000 amount would be indexed to account for the effects of inflation, as measured by annual changes in the Consumer Price Index after July 31, 1980. Where more than one individual makes contributions to the account of a particular beneficiary, the $1,000 would be allocated proportionally among all contributors. A penalty tax would be imposed upon excess contribution to the account.

Eligible beneficiary.—An education savings account would be a trust established for no more than one eligible individual. Moreover, only one eligible education savings account could be created for any one individual. An eligible individual would be either the taxpayer or a child of the taxpayer so long as the taxpayer or child is either under age 21 or is not enrolled as a full-time student at an eligible educational institution for more than 4 weeks during that calendar year.

Requirements of account.—The governing instrument of the trust must provide that (1) the trust can only accept contributions of cash, stock, bonds or other readily tradeable assets, (2) contributions cannot be accepted that exceed $1,000 per year, (3) a bank (or other qualified person) must be the trustee, (4) no part of the trust's assets may be invested in life insurance contracts (other than contracts the beneficiary of which is the trust and the face amount of which does not exceed the amount by which the maximum amount which can be contributed to the account exceeds the sum of the amounts contributed to the account for all taxable years), (5) the assets of the trust may be invested in accordance with the directions of the contributors to the trust, (6) the assets of the trust may not be commingled with the other property except in a common trust or investment fund, and (7) any unspent amount must be returned to the contributors when the beneficiary attains age 26.

Taxation of distributions for educational purposes.—Distributions out of the trust to pay for educational expenses of the beneficiary would be taxed to the beneficiary in 10 equal parts over a 10-year period beginning when the beneficiary reaches age 25. Education expenses include tuition and fees at an eligible educational institution, fees, books, supplies, and equipment required for courses of instruction at an eligible eductaional institution, and a reasonable allowance for meals and lodging. An eligible educational institution would be either an institution of higher education or a vocational school.

Taxation of distribution for noneducational purposes.—Amounts distributed out of the education savings account that are not for the educational expenses of the beneficiary would be includable in the gross income of the contributors to the account in the year of distribution. However, there would be a special rule which allows removal of excess contributions and related income before the due date of the return for the year of contribution. Pledging of the account or any portion thereof would be treated as a distribution to the person pledging the account. In addition, a penalty tax would be imposed equal to 10 percent of all distributions not used for educational expenses of the beneficiary. The penalty tax would not apply if the contributor is disabled.

Taxation of account.—The education savings account would be exempt from Federal income taxes other than the tax on unrelated trade or business income. The exemption of the account would be lost if any contributor engages in a prohibited transaction with the account. In such a case, the account would be treated as distributing all of its assets on the first day of the year when the prohibited transaction occurred.

Gift tax treatment of contributions.—Deductible contributions to the account would be treated as gifts of a present interest in property and, thus, would be eligible for the $3,000 per year, per donee gift tax exemption.

Housing savings account

In general.—The bill also would allow a deduction of up to $1,500 ($3,000 in the case of a joint return) for amounts contributed to a housing savings account. The account would be generally exempt from tax. Distributions out of the account for use in connection with the purchase of the first dwelling purchased by the payee or distributee which constitutes his principal residence would not be taxed to the payee but would reduce the basis of the dwelling and would reduce the taxpayer's one time $100,000 exemption for gain on a principal residence.

Deduction allowed.—An individual would be allowed a deduction for contributions of cash and the fair market value of stocks, bonds, or other readily tradeable securities to a housing savings account. The deduction would be allowed whether or not the individual itemizes his deductions.

Limitation on maximum deduction.—The maximum amount allowed as a deduction for transfers to a housing savings account would be $1,500 per year ($3,000 in the case of a joint return). In addition, there would be a lifetime maximum deduction of $15,000 ($30,000 in the case of a joint return). These amounts would be indexed to account for the effects of inflation, as measured by annual changes in the Consumer Price Index after July 31, 1980.

Requirements of account.—A housing savings account would be a trust established for the exclusive benefit of an individual and his spouse (if any). The governing instrument of the trust must provide that (1) the trust can only accept contributions of cash or stock, bonds, or other readily tradeable assets, (2) contributions cannot be accepted that exceed $1,500 per year ($3,000 if the individual is married), (3) total contributions in excess of $15,000 ($30,000 if the individual is married and filing a joint return) cannot be accepted, (4) a bank (or other qualified person) must be trustee, (5) no part of the trust's assets may be invested in life insurane contracts, (6) the assets of the trust may be invested in accordance with the directions of the contributors to the thrust, (7) the assets of the trust may not be commingled with other property except in a common trust or investment fund, and (8) the entire corpus of the trust is to be distributed to the contributors not later than 10 years from the date on which contributions were first made to the trust.

Taxation of distributions to purchase first principal residence.—Distributions out of a housing savings account that are used in connection with the purchase of a first dwelling by the payee, which becomes the principal residence, would not be taxed to the payee. However, the basis of the dwelling would be reduced by such distributions. In addition, the $100,000 one-time exclusion for persons aged 55 or older on the gain from the sale of a principal residence would be reduced by the amount of these distributions.

Taxation of other distributions.—Amounts distributed out of the housing savings account that are not used for the purchase of a first dwelling of the beneficiary would be includible in the gross income of the contributors to the account in the year of distribution. However, there would be a special rule which allows removal of excess contributions and related income before the due date of the return for the year of contribution. Pledging of the account or any portion thereof would be treated as a distribution to the person pledging the account. The bill contains a special rule that allows transfer of all or a portion of the account incident to a divorce. In addition, a penalty tax would be imposed equal to 10 percent of all distributions not used for the purchase of a first dwelling of the beneficiary. The penalty tax would not apply if the contributor is disabled.

Taxation of account.—The housing savings account would be exempt from Federal income taxes other than the tax on unrelated trade or business income. The exemption of the account would be lost if any contributor engages in a prohibited transaction (within the meaning of Code sec. 4975) with the account. In such a case, the account would be treated as distributing all of its assets on the first day of the year when the prohibited transaction occurred.

Effective date

The section of the bill relating to education savings accounts would be effective with respect to taxable years beginning after December 31, 1981.

The section of the bill relating to housing savings accounts would be effective with respect to taxable years beginning after December 31, 1980.

Revenue effect

It is estimated that this bill will decrease budget receipts by $309 million in fiscal year 1981, $5,698 million in 1982, $5,640 million in 1983, $6,781 million in 1984 and $7,847 million in 1985.

3. S. 243—Senators Chafee, Warner, and Thurmond Savings and Retirement Income Incentive Act of 1981

a. Permanent interest and divided exclusion (sec. 2 of the bill)

Present law

Individuals may exclude from gross income up to $200 ($400 on a joint return) of dividends and interest income received from domestic sources (Code sec. 116). This provision is effective for taxable years beginning after December 31, 1980, and before January 1, 1983. After 1982, the exclusion reverts to prior law, under which the exclusion applied only to dividends and was limited to $100 ($200 in the case of a joint return). This is reflected in the revenue estimates (below) for 1983 and later.

Issues

This section of the bill specifically raises the issue (1) whether the partial exclusion for dividends and interest should be made permanent, and (2) whether the amount of the exclusion should be increased for individuals who are age 65 and older.

Explanation of provision

Section 2 of S. 243 would make permanent the partial exclusion of dividends and interest by individuals.

In addition, the provision would increase the aggregate amount excludible to $500 ($1,000 in the case of a joint return) for an individual who attains age 65 before the close of the taxable year or who is married, at the close of the taxable year, to an individual who is at least 65 years old.

Effective date

The provisions of section 2 of S. 243 would be effective for taxable years beginning after December 31, 1980.

Revenue effect

Fiscal year budget receipts would be reduced by $105 million in 1981, $771 million in 1982, $1,742 million in 1983, $4,278 million in 1984, and $4,391 million in 1985.

b. Individual retirement and savings accounts (secs. 3–6 of the bill)

Present law

An individual generally is entitled to deduct the amount contributed to an individual retirement account or annuity, or used to purchase retirement bonds (referred to collectively as "IRAs"). The limitation on the deduction for a taxable year is generally the lesser of 15% of compensation for the year or $1,500. Under a spousal IRA, the $1,500 contribution limit is increased to $1,750 for a year if (1) the contribution is divided equally between an individual and the spouse of the individual, and (2) the spouse has no compensation for the year. However, no IRA deduction is allowed for a taxable year to an individual who is an active participant during any part of the taxable year in a qualified pension, profit-sharing, or stock bonus plan, a tax-sheltered annuity maintained by a tax-exempt organization or educational institution, or a governmental plan (whether or not qualified). Except for tax-free roll-overs and certain amounts paid for life insurance, nondeductible contributions are not permitted to be made to an IRA. Income and gain on amounts held under an IRA are not taxed until distributed. All distributions from IRAs are includible in gross income. Distributions may be made from an IRA without penalty after age 59½ or in the event of disability or death. Amounts held in an IRA can qualify for exclusions under the estate tax and gift tax rules.

Many qualified plans provide for contributions by both the employer and the employee. In many cases, the employee contributions are mandatory (i.e., required as a condition of employment, a condition of participation in the plan, or a condition of obtaining additional employer-derived benefits). In other cases, employee contributions are voluntary, and the amount, within limits, is left to the discretion of the employee. A plan can provide for both mandatory and voluntary employee contributions. In any case, neither employer nor employee contributions to a qualified retirement plan may discriminate in favor of employees who are officers, shareholders, or highly compensated. Generally, in the case of voluntary employee contributions, within certain limits, there is presumed to be no discrimination so long as there is an equal opportunity for all employees to make such contributions. Income allocable to an employee's contributions to a qualified plan is generally not taxed to the plan or to the employee before the income is distributed or made available to the employee or the employee's beneficiary. However, the employee is not entitled to a deduction or exclusion for employee contributions to the plan. Benefits held in a qualified plan can qualify for exclusions under the estate tax and gift tax rules to the extent the benefits are not attributable to employee contributions.

In the case of tax-sheltered annuities (including custodial accounts investing in shares of a regulated investment company) purchased by certain tax-exempt institutions for their employees or purchased by schools for teachers, employees are entitled to an exclusion, within limits, from gross income for amounts paid by the employer on a salary reduction basis. Amounts invested in a tax sheltered annuity purchased by a tax-exempt organization can qualify for exclusions under the estate tax and gift tax rules.

Issue

The issues are whether the present tax incentives for individual retirement savings accounts should be expanded and whether distribution from the accounts also should be allowed for educational purposes and for the purchase of the first principal residence.

Explanation of the bill

Deductible contributions

The bill would increase the annual limit on deductible retirement savings contributions to 100 percent of the first $2,000 of compensation includible in gross income. In addition, the bill would extend eligibility for deductible retirement savings contributions to individuals who are active participants in qualified plans, tax-sheltered annuity programs, or governmental plans. The bill would delete the special $1,750 deduction limitation for spousal IRAs.

Under the bill, deductible retirement savings contributions could be made by an individual to (1) a qualified plan in which the individual is an active participant or (2) to an IRA. No deduction would be allowed, however, for mandatory employee contributions to a plan. Contributions to a qualified plan or to an IRA made before the time for filing the tax return for a year could be taken into account as if made on the last day of the year for which the return is filed.

Under the bill, benefits attributable to deductible employee contributions to a plan would be taxed under the same rules that apply to benefits attributable to employer contributions. Accordingly, these benefits would generally be taxed only when distributed or made available to the employee or a beneficiary, unless rolled over tax-free to another qualified plan or to an IRA. Such benefits could also qualify for exclusion under the estate and gift tax provisions.

Deductible employee contributions to a plan would be treated as employee contributions, however, in testing whether the plan meets the requirements for tax-qualified status and whether the plan meets the requirements of ERISA.

The bill provides for simplified reports with respect to deductible employee contributions received by plans.

Nondeductible contributions

The bill would allow nondeductible contributions to be made to an IRA. Although no deduction would be allowed for the contributions and they would not be excluded from estate or gift tax under the usual rules applicable to IRAs, the earnings attributable to nondeductible contributions would not be taxed until distributed. Nondeductible contributions would be subject to an annual limit of $2,000. Nondeductible contributions of up to $8,000 could be made over an individual's lifetime in addition to the amount contributed under the $2,000 annual limit for nondeductible contributions. Under the bill, the limits for nondeductible contributions would be applied only after the limit on deductible contributions for a year is exceeded.

Distributions for education and housing purposes

Where nondeductible contributions have been made to an IRA, distributions from the IRA would be allocated under the usual annuity rules to determine the taxable portion, so that the part of each distribution consisting of nondeductible contributions would not be taxed. The bill would permit distributions to be made from an IRA without penalty to pay for certain educational expenses and would permit distributions in connection with the purchase of the first dwelling purchased by the owner of the IRA if the dwelling is used as that individual's principal residence. Withdrawals for educational expenses or the purchase of a dwelling could not be less than $2,000 and could not reduce the amount held in the IRA below $2,000. Also, total withdrawals for these purposes could not accumulate to more than $10,000.

Under the bill, withdrawals for educational expenses could be made to pay for (1) tuition and fees at an educational institution, (2) fees, books, supplies, and equipment for courses of instruction, and (3) a reasonable allowance for meals and lodging. An institution would qualify as an educational institution if it is an institution of higher education [2] or a vocational school.[3]

Effective dates

Generally, the amendments made by the bill would apply to taxable years beginning after 1980. The estate and gift tax amendments would apply to estates of decedents who die after 1980 and to transfers made after 1980 (respectively).

Revenue effect

It is estimated that this bill will decrease budget receipts by $118 million in fiscal year 1981, $2,754 million in 1982, $2,992 million in 1983, $3,620 million in 1984 and $3,907 million in 1985.

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[2] As defined in section 1201(a) or 491(b) of the Higher Education Act of 1965.
[3] As defined in section 195(2) of the Vocational Education Act of 1963 in any State (as defined in section 195(8) of that Act).

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