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Retirement Savings Accounts: President's Budget Proposal for FY2005

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Summary

The President's proposed budget for FY2005 would establish *Lifetime Savings Accounts* (LSAs) that could be used for any type of saving and from which withdrawals could be made at any time, and *Retirement Savings Accounts* (RSAs) that could be used for retirement saving. Additionally, beginning in 2005, several kinds of employer-sponsored retirement plans would be consolidated into *Employer Retirement Savings Accounts* (ERSAs). Qualification rules in the tax code would be simplified, while other rules governing ERSAs would conform substantially to those that apply to §401(k) plans. This report will be updated as legislative developments occur.

Lifetime Savings Accounts. Individuals of any age could contribute up to \$5,000 annually, indexed to inflation, to a *Lifetime Savings Account* (LSA), regardless of whether they had any earnings that year. No upper income limit would apply to LSA participants. Contributions would not be deductible, but investment earnings would accumulate tax-free. Distributions from the account would be tax-free, regardless of the individual's age or the purpose for which the distribution was used. There would be no required distributions from LSAs during the account owner's lifetime. The annual contribution limit of \$5,000 would apply to all *Lifetime Savings Accounts* in an individual's name, but contributions over this amount could be made to accounts owned by others. An account in a child's name would become the child's property upon reaching the age of majority, as defined under applicable state law. An account owner could roll over the balance in an LSA to an LSA owned by his or her spouse, but not to anyone else.

Balances in, *Coverdell Education Savings Accounts* (ESAs), and Section 529 *Qualified State Tuition Plans* (QSTPs) could be converted to LSAs up to December 31, 2005, subject to the following rules: Amounts could be rolled into an LSA from a QSTP only if the individual was the beneficiary of the QSTP on December 31, 2003. The amount that could be rolled over to an LSA from an ESA would be limited to the account value on December 31, 2003, plus any contributions to and earnings on the accounts in 2004. The amount that could be rolled over to any LSA from a QSTP would be limited to the sum of (1) the lesser of \$50,000 or the amount in the QSTP as of December 31, 2003, plus (2) any contributions and earnings to the QSTP during 2004. Total rollovers

to an individual's LSA attributable to 2004 contributions to the individual's ESAs and QSTPs could not exceed \$5,000, plus any earnings on those contributions.

Retirement Savings Accounts. Individuals of any age could contribute up to \$5,000 per year from earned income to a *Retirement Savings Account* (RSA). The maximum annual contribution would be indexed to inflation. For a married couple, the maximum contribution would be the lesser of annual earned income or \$10,000, also indexed to inflation. No upper income limit would apply to RSA contributors. Contributions to an RSA would not be tax-deductible, but qualified distributions would be tax-free. Qualified distributions would be those made after age 58 or if the account owner died or became disabled. All other distributions would be nonqualified distributions. Nonqualified distributions in excess of contributions would be subject to both the regular income tax and a 10% excise tax. Distributions would be deemed to come from contributions first. Distributions from RSAs would not be required during the account owner's lifetime.

Current "Roth IRAs" would be renamed RSAs and would be subject to the rules for RSAs. Owners of traditional IRAs could convert them to RSAs. Converted amounts in excess of nondeductible contributions (the account basis) would be taxed as ordinary income. Conversions before January 1, 2006 could be included in taxable income in four yearly installments. Conversions after January 1, 2006 would be taxed in the year of the conversion. Under current law, individuals and couples with incomes in excess of \$100,000 may not convert a traditional IRA to a Roth IRA. There would be no income limit on conversions of traditional IRAs to RSAs. Traditional IRAs could not accept new contributions after 2004 except to receive rollovers from employer-sponsored retirement plans. Distributions from employer plans could be rolled over to an RSA by including the rollover amount (excluding basis) in gross income in the year of the conversion.

Employer Retirement Savings Accounts. Beginning in 2005, §401(k), §403(b), and governmental §457 plans would be consolidated into *Employer Retirement Savings Accounts* (ERSAs), which would be available to all employers.¹ Qualification rules under the Internal Revenue Code would be simplified. Other rules governing ERSAs would conform substantially to those that apply to §401(k) plans. Employees could defer wages up to \$14,000 in 2005, increasing to \$15,000 in 2006. Employees age 50 or older could defer an additional \$4,000 in 2005, increasing to \$5,000 in 2006. The limit on "annual additions" (employee salary deferrals plus employer contributions) would be the lesser of 100% of compensation or \$41,000. Employee contributions to an ERSA could be made either on a pre-tax or after-tax basis. Distributions of after-tax employee contributions and qualified distributions of investment earnings would be tax-free. All other distributions would be subject to the income tax. The requirement for distributions to begin at age 70½ (or retirement, if later) would apply to ERSAs. Current §401(k) plans would be renamed ERSAs and could continue to operate as before. Section 403(b) plans and governmental §457 plans could be operated as ERSAs, or operated separately. If not converted to ERSAs, these plans could not accept new contributions after 2005.

¹ The consolidation would also include *Savings Incentive Match Plans for Employees* (SIMPLE plans) and *Simplified Employee Pension* (SEP) plans.

Special Rule for Small Employers. Employers with 10 or fewer employees who earned \$5,000 or more during the prior year would be allowed to fund an ERSA by contributing to a custodial account, similar to a current-law IRA, provided that the employer’s contributions satisfy a design-based “safe harbor.” This would relieve firms with 10 or fewer employees from most of the fiduciary obligations, reporting rules, and disclosure requirements that apply to larger employers under the Employee Retirement Income Security Act (ERISA), as is the case under current law for the SIMPLE IRA.

Current-law Requirements for Employer-sponsored Retirement Savings Plans. Tax-qualified retirement plans cannot discriminate in favor of *highly-compensated employees* (HCEs) with regard to *coverage, amount* of benefits, or *availability* of benefits. A “highly compensated employee” is defined in law as any employee who owns 5% or more of the company or whose compensation exceeds \$90,000 (indexed to inflation). An employer can elect to count as HCEs only employees who rank in the top 20% of compensation in the firm, but it must include all 5% owners.

Coverage and Nondiscrimination. To be tax-qualified, a §401(k) plan must satisfy one of two tests: either the proportion of non-highly compensated employees (NHCEs) covered by the plan must be at least 70% of the proportion of highly compensated employees (HCEs) covered by the plan, or the average contribution percentage for NHCEs must be at least 70% of the average contribution percentage for HCEs.² Contributions to a plan cannot discriminate in favor of HCEs. Plans that have after-tax contributions or matching contributions are subject to the “actual contribution percentage” (ACP) test, which measures the contribution rate to HCEs’ accounts relative to the contribution rate to NHCEs’ accounts. Some §403(b) plans are subject to nondiscrimination rules; §457 plans generally are not. The actual contribution percentage of HCEs in a §401(k) plan generally cannot exceed the limits shown in **Table 1**.

Table 1. Maximum Average 401(k) Contributions for Highly Compensated Employees

| Nonhighly compensated employees (NHCEs) | Highly compensated employees (HCEs) |
|--|--|
| <i>Maximum average deferral and match:</i> | <i>Maximum average deferral and match:</i> |
| 2% of pay or less | NHCE percentage X 2 |
| 2% to 8% of pay | NHCE percentage + 2% |
| 8% of pay or more | NHCE percentage X 1.25 |

Note: “Deferral and match” is the sum of employer and employee contributions.

Any of three “safe-harbor” designs are deemed to satisfy the ACP test automatically for employer matching contributions (up to 6% of compensation):

- The employer matches 100% of employee elective deferrals up to 3% of compensation, and 50% of elective deferrals between 3% and 5% of compensation, and all employer matching contributions are fully vested.

² For the purposes of the latter test, the average contribution percentage is defined as all employer contributions divided by total compensation. A third test — that at least 70% of NHCEs must be covered by the plan — will automatically satisfy the first test listed above.

- Employer matching contributions can follow any other matching formula that results in total matching contributions that are no less than under the first design. All employer matching contributions vest immediately.
- The employer automatically contributes an amount equal to at least 3% of pay for all eligible NHCEs. Employer contributions vest immediately.

All §401(k) plans must satisfy an “actual deferral percentage” (ADP) test, which measures employees’ elective-deferral rates. The same numerical limits are used as under the ACP test. Three “safe-harbor” designs, similar to the safe-harbor designs for the ACP test, are deemed to satisfy the ADP test automatically. In addition, “cross-testing” allows defined-contribution plans to satisfy the nondiscrimination tests based on projected account balances at retirement age, rather than current contribution rates. This permits bigger contributions for older workers. Because higher-paid employees receive proportionally smaller Social Security benefits relative to earnings than lower-paid workers, employers are permitted to make larger contributions on earnings in excess of the Social Security wage base (\$87,900 for 2004). Regulations limit the size of the *permitted disparity* in favor of workers whose earnings are above the wage base.

Vesting; “Top-heavy” plans. Employee contributions to an employer-sponsored plan are immediately and fully vested. Employer contributions must vest *at least* as quickly as mandated under law. Under *cliff vesting*, employees must be fully vested in *matching contributions* after 3 years of service and fully vested in all other employer contributions after 5 years of service. Under *graded vesting*, employees must be 20% vested in *matching contributions* after 2 years of service and fully vested after 6 years of service. With respect to all other employer contributions, employees must be 20% vested after 3 years of service and fully vested after 7 years of service. Additional requirements apply to plans in which more than 60% of the benefits accrue to “key” employees, defined as (1) company officers whose compensation exceeds \$130,000, (2) those who own more than 5% of the company, and (3) those who own more than 1% *and* have compensation that exceeds \$150,000. Top heavy plans are subject to an accelerated vesting schedule and stricter requirements for minimum benefits and contributions for non-key employees.

Administration’s proposal. The President’s proposed budget for FY2005 would substantially change several aspects of employment-based retirement savings plans.

ERSA Nondiscrimination Testing. There would be a single test for nondiscrimination with respect to contributions. If the non-highly compensated employees’ average contribution is 6% of pay or less, the average contribution of highly-compensated employees could be no more than twice the NHCE percentage. If the average contribution of the non-highly compensated employees exceeds 6%, there would be no nondiscrimination test.³ Plans sponsored by state and local governments would be exempted. Plans sponsored by charitable organizations would be exempted unless they permit after-tax employee contributions or make matching contributions, but all employees would have to be allowed to participate. The ACP and ADP tests would be repealed. A “safe harbor” plan design would satisfy the nondiscrimination test for ERSAs. A plan would qualify under the safe harbor if all NHCEs eligible to participate

³ The contribution percentage would be calculated for each employee as the sum of all employee and employer contributions divided by the employee’s compensation.

in the plan are eligible to receive fully vested employer contributions equal to at least 3% of pay. Both matching and non-elective (i.e., automatic) employer contributions would count toward satisfying the nondiscrimination test. However, if the employer contributions of 3% of compensation for NHCEs are *matching* contributions rather than *non-elective* contributions, the match formula must be one of two qualifying formulas:

- An employer match of 50% of employee elective deferrals up to 6% of pay, or
- Any alternative formula in which (a) the rate of the matching contribution does not increase as the employee's elective contributions increase, and (b) the aggregate amount of matching contributions at a given rate of elective deferrals is at least equal to the aggregate amount of matching contributions that would be made if the match were made on the basis of the percentages described in the first formula. Also, the rate of matching contribution with respect to an HCE at any rate of elective contribution could be greater than the matching rate for an NHCE.

The date for after-tax "Roth" contributions to ERSAs would be January 1, 2005. (Under current law participants in §401(k) and §403(b) plans can elect "Roth" treatment for their contributions on January 1, 2006. "Roth" contributions would not be excluded from income, but qualified distributions would be tax-free.)

Coverage, top-heavy plans, permitted disparity, cross-testing, and highly-compensated employees. Plans would continue to be required to cover a percentage of non-highly compensated employees that is at least 70% of the percentage of highly compensated employees that are covered. This test would be applied in the same manner as under current law. The average deferral percentage (ADP) test and the average contribution percentage (ACP) test would be repealed. The current-law top-heavy rules would be retained. The permitted disparity rules and cross-testing rules would continue as under current law. Both the definition of compensation and the definition of a highly-compensated employee would remain as in current law.

The Treasury Department has offered several reasons for the proposed changes to individual retirement accounts and employer-sponsored retirement plans. They state that:

- Savings accounts currently are subject to different rules regarding eligibility, contributions, withdrawals, and tax treatment. This creates complexity and redundancy in the tax code;
- Taxpayers must determine their eligibility for each account, and must re-evaluate their eligibility over time as their financial circumstances change;
- The current list of non-retirement exceptions within IRAs weakens the focus on retirement saving. Restrictions on withdrawals and additional taxes on early distributions discourage many taxpayers from making contributions;
- Consolidating the three types of IRAs under current law into one account, and creating a new account that could be used for any reason would simplify the taxpayer's decision-making process while further encouraging savings;
- Simplifying the rules, making savings opportunities universally available, and making it easier for people to set money aside through direct deposit would promote and encourage financial education and retirement planning.

Policy Issues. One reason that small employers sponsor retirement plans for their employees is so the business owners can participate in the plan, which allows them to save more for retirement on a tax-deferred basis than they could save in an IRA. The maximum annual salary deferral under a 401(k) plan is \$13,000 in 2004, more than double the \$6,000 that a married couple can contribute to an IRA. In its budget for FY2004, the Administration proposed maximum annual contributions to RSAs and LSAs of \$7,500 per account for each individual. Some pension specialists were concerned that small business owners would be less likely to sponsor retirement plans for their workers if married couples could together contribute as much as \$30,000 per year to RSAs and LSAs. In response to these concerns, the Administration has reduced the proposed maximum annual contributions to both RSAs and LSAs from \$7,500 to \$5,000 each. The proposal for FY2005 also would allow firms with 10 or fewer employees to establish “custodial account” ERSA plans, similar to SIMPLE IRAs. This would relieve very small firms of many of the administrative tasks that are required of larger firms that sponsor retirement plans. As a result of these changes, the American Society of Pension Actuaries (ASPA) has taken the position that the proposals “will not negatively affect small business retirement plan coverage.”⁴

Other analysts are concerned that the proposals would benefit mainly higher-income individuals who do not need additional tax incentives to save for retirement, and that the plans will substantially reduce future federal tax revenue without any net increase in total national saving. In analyzing a similar proposal in the President’s budget for FY2004, the Congressional Budget Office concluded that “most taxpayers would simply save the same amount in one of the new accounts as they would have saved in one of their current tax free accounts,” and that “people who currently have assets in taxable accounts could reduce their tax liability by selling those assets and putting the cash from the sale into the tax preferred accounts — an action that would have no effect on private saving.”⁵ Another concern is that Lifetime Savings Account would promote consumption over savings because account balances could be withdrawn at any time for any purpose. The President of the American Council of Life Insurers has said that “LSAs will harm the retirement security of American families by siphoning long-term savings into a short-term vehicle where it would be accessed early and often for non-retirement purposes.”⁶ Another financial institution has said that “LSAs target the wrong kind of savings. Because individual savers can withdraw money for any reason at any time with no penalty, investors will have little incentive to save long-term for financial security at retirement.”⁷

⁴ *Administration Announces Revised Savings Proposals*, ASPA press release, Feb. 2, 2004. The ASPA also stated its position that “the SAVER’s credit [P.L. 107-16, 2001], which provides a tax credit for retirement savings contributions by lower income individuals, should apply to RSA and ERSA contributions, and should be expanded to cover taxpayers with slightly higher/more moderate incomes.”

⁵ *An Analysis of the President’s Budgetary Proposals for Fiscal Year 2004*, Congressional Budget Office, Washington, DC, March 2003, page 25.

⁶ “Bush to Tinker with Proposals to Revamp Savings Plans,” *Congress Daily*, January 30, 2004.

⁷ J. Barry Griswell, chairman, Principal Financial Group, press release, January 28, 2004.