

## TAX INCENTIVES

### Simplify and Encourage Saving

#### **EXPAND TAX-FREE SAVINGS OPPORTUNITIES**

##### **Current Law**

Current law provides multiple tax-preferred individual savings accounts to encourage savings for retirement, education, and health expenses. The accounts have overlapping goals but are subject to different sets of rules regulating eligibility, contribution limits, tax treatment, and withdrawal restrictions. Individual Retirement Accounts (IRAs), including traditional, Roth, and nondeductible IRAs, are primarily intended to encourage retirement saving, but can also be used for certain education, medical, and other non-retirement expenses. Each of the three types of IRAs is subject to a different set of rules regulating eligibility and tax treatment. Coverdell Education Savings Accounts (ESAs) and Section 529 Qualified Tuition Plans (QTPs) are both intended to encourage saving for education, but each is subject to different rules. Archer Medical Savings Accounts (MSAs) and Health Savings Accounts (HSAs) are intended to encourage saving for medical expenses.

**Individual Retirement Accounts:** Under current law, individuals under age 70½ may make contributions to a traditional IRA, subject to certain limits. The contributions are generally deductible; however, the deduction is phased out for workers with incomes above certain levels who are covered by an employer-sponsored retirement plan. For taxpayers covered by employer-plans in 2004, the deduction is phased out for single and head-of-household filers with modified-AGI<sup>3</sup> between \$45,000 and \$55,000 (increasing to \$50,000 to \$60,000 in 2005), for married filing jointly filers with modified-AGI between \$65,000 and \$75,000 (increasing in stages to \$80,000 to \$100,000 in 2007), and for married filing separately filers with modified-AGI between \$0 and \$10,000. For a married, filing jointly taxpayer who is not covered, but whose spouse is covered by an employer-sponsored retirement plan, the deduction is phased out with modified-AGI between \$150,000 and \$160,000. Account earnings are not includible in gross income until distributed. Distributions (including both contributions and account earnings) are includible in gross income.

To the extent a taxpayer cannot or does not make deductible contributions to a traditional IRA, a taxpayer under age 70½ may make nondeductible contributions. In this case, distributions representing a return of basis are not includible in gross income, while distributions representing account earnings are includible in gross income. There is no income limit for nondeductible contributions to a traditional IRA.

Individuals of any age may make contributions to a Roth IRA. Allowable contributions are phased out for workers with incomes above certain levels. Contributions are phased out for

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<sup>3</sup> AGI plus income from education savings bonds, interest paid on education loans, employer-provided adoption assistance benefits, IRA deductions, deductions for qualified higher education expenses, and certain other adjustments.

single or head-of-household filers with modified-AGI between \$95,000 and \$110,000, for married filing jointly filers with modified-AGI between \$150,000 and \$160,000, and for married filing-separate filers with modified-AGI between \$0 and \$10,000. Account earnings accumulate tax free, and qualified distributions (including account earnings) are not included in gross income for income tax purposes. Nonqualified distributions from Roth IRAs are included in income (to the extent they exceed basis) and subject to an additional tax. Distributions are deemed to come from basis first.

The annual aggregate limit on contributions to all of a taxpayer's IRAs (traditional, nondeductible, and Roth) is the lesser of earnings or \$3,000 for 2004 (\$3,500 for individuals age 50 and over). The contribution limit is scheduled to increase in stages to \$5,000 (\$6,000 for individuals age 50 and over) in 2008.

Taxpayers with AGI of \$100,000 or less and who are not married filing separately can convert a traditional IRA to a Roth IRA. In general, the conversion amount is included in gross income (but not for purposes of the \$100,000 limit).

Early distributions from IRAs are generally subject to an additional 10 percent tax. The tax is imposed on the portion of an early distribution that is includible in gross income. It applies in addition to ordinary income taxes on the distribution. The additional tax does not apply to a rollover to an employer plan or IRA, or if the distribution is made in the cases of death or disability, certain medical expenses, first-time homebuyer expenses, qualified higher-education expenses, health-insurance expenses of unemployed individuals, or as part of a series of substantially equal periodic payments.

Minimum distribution rules require that, beginning at age 70½, the entire amount of a traditional IRA be distributed over the expected life of the individual (or the joint lives of the individual and a designated beneficiary). Roth IRAs are not subject to minimum distribution rules during the account owner's lifetime.

Coverdell Education Savings Accounts: Taxpayers may elect to contribute up to \$2,000 per year to a Coverdell Education Savings Account (ESA) for beneficiaries under age 18. The contribution limit is phased out for single filers with modified-AGI between \$95,000 and \$110,000 and for joint filers with modified-AGI between \$150,000 and \$160,000. Contributions are not deductible, but earnings on contributions accumulate tax-free. Distributions are excludable from gross income to the extent they do not exceed qualified education expenses that are incurred during the year the distributions are made and that are not used to claim another tax benefit (such as an education tax credit or a tax-free distribution from a qualified tuition program). The earnings portion of a distribution not used to cover qualified education expenses is includible in the gross income of the beneficiary and is generally subject to an additional 10 percent tax.

Except in the case of a special needs beneficiary, when a beneficiary reaches age 30, the account balance is deemed to have been distributed for nonqualified purposes. However, prior to the beneficiary reaching age 30, tax-free (and penalty-free) rollovers of account balances may be made to an ESA benefiting another family member.

Section 529 Qualified Tuition Programs: Contributions to a QTP are not deductible from income for federal tax purposes, but earnings on contributions accumulate tax-free. Taxpayers may exclude from gross income amounts distributed from a QTP and used for qualified higher education expenses, so long as the distribution is not used for the same educational expenses for which another tax benefit (such as an education tax credit or a tax-free distribution from an ESA) is claimed. Nonqualified distributions are subject to an additional tax. A change in the designated beneficiary of an account is not treated as a distribution, and therefore is not subject to income tax, if the new beneficiary is a member of the family of the prior beneficiary. Neither contributors nor beneficiaries may direct the investment of the account.

There is no specific dollar cap on annual contributions to a QTP. In addition, there is no limit on contributions to a QTP account based on the contributor's income, contributions are allowed at any time during the beneficiary's lifetime, and the account can remain open after the beneficiary reaches age 30. However, a QTP must provide adequate safeguards to prevent contributions on behalf of a designated beneficiary in excess of amounts necessary to provide for the qualified higher education expenses of the beneficiary.

Some states allow contributions to be excluded from income for state income tax purposes.

Health Savings Accounts: Individuals who are covered by a qualifying high deductible health plan and not covered by any non-high deductible health plan other than certain permitted or disregarded coverage may contribute to a health savings account (HSA) that can be used to reimburse the individuals' and their dependents' health expenses. Employers may also make contributions to employees' HSAs. The high deductible health plan may be provided by an employer or purchased in the individual insurance market. Individuals who are eligible for Medicare or to be claimed as a dependent on someone else's return may not contribute to an HSA. Contributions to HSAs are deductible and qualified distributions are excluded from gross income. Nonqualified distributions are subject to income tax and, if taken prior to age 65, an additional 10 percent tax.

Archer Medical Savings Accounts: Self-employed individuals and individuals employed by small employers maintaining a high deductible health plan (defined more restrictively than under the HSA) are allowed to accumulate funds in an Archer Medical Savings Account (MSA) on a tax-preferred basis to pay for medical expenses. An individual is eligible to establish an MSA only if the employee (or the employee's spouse) is covered by a high-deductible health plan (and not covered by any non-high deductible health plan). Although individuals with MSAs can continue to contribute to them as long as they are with an MSA participating employer, no new MSAs are permitted after the end of 2003 except with respect to individuals being hired after 2003 by an MSA-participating employer. Contributions to MSAs are deductible and qualified distributions are excluded from gross income. Nonqualified distributions are subject to income tax and, if taken prior to age 65, an additional 15 percent tax.

### **Reasons for Change**

The plethora of individual savings accounts, each subject to different rules regarding eligibility, contributions, tax treatment, and withdrawal, creates complexity and redundancy in the Code.

Taxpayers must determine their eligibility for each account separately and then must decide which plan or plans are best for them given their circumstances. Furthermore, as their circumstances change over time, taxpayers must continually re-evaluate their eligibility for each plan and which best meets their needs. The current list of non-retirement exceptions within IRAs weakens the focus on retirement saving, and the IRA exceptions and special purpose savings vehicles place a burden on taxpayers to document that withdrawals are used for certain purposes that Congress has deemed qualified. In addition, the restrictions on withdrawals and additional tax on early distributions discourage many taxpayers from making contributions because they are concerned about the inability to access the funds should they need them. Consolidating the three types of IRAs under current law into one account dedicated solely to retirement, and creating a new account that could be used to save for any reason would simplify the taxpayer's decision-making process while further encouraging savings.

Savings will be further simplified and encouraged by administrative changes to the tax filing process that will allow taxpayers to direct that their tax refunds be directly deposited into more than one account. Consequently, taxpayers will be able, for example, to direct that a portion of their tax refunds be deposited into a Lifetime Savings Account or Retirement Savings Account described below. Simplifying the rules, making savings opportunities universally available, and making it easier for people to set money aside through direct deposit will complement the Administration's commitment to programs focusing on financial education and, specifically, retirement planning.

### **Proposal**

The proposal would consolidate the three types of current law IRAs into a single account: a Retirement Savings Account (RSA). RSAs would be dedicated solely to retirement savings; other withdrawals would be subject to tax and penalty as described below. Instead of a list of exceptions for penalty-free early withdrawals, a new account, a Lifetime Savings Account (LSA) would be created that could be used for savings for any purpose, including augmenting retirement savings, health care, covering emergencies, and education.

Individuals could contribute up to \$5,000 per year (or earnings includible in gross income, if less) to their RSA. As under current law IRAs, for an individual who is married filing a joint return, the compensation limitation will only be binding if the combined includible compensation of the spouses is less than \$10,000. No income limits would apply to RSA contributions. Contributions would have to be in cash. Contributions would be nondeductible, but earnings would accumulate tax-free, and qualified distributions would be excluded from gross income. The RSA contribution limit would be indexed for inflation.

Qualified distributions from the retirement account would be distributions made after age 58 or in the event of death or disability. Any other distribution would be a nonqualified distribution and, as with current non-qualified distributions from Roth IRAs, would be includible in income (to the extent it exceeds basis) and subject to a 10 percent additional tax. Distributions would be deemed to come from basis first. As with current law Roth IRAs, no minimum required distribution rules would apply to RSAs during the account owner's lifetime. Married individuals could roll amounts from their RSA over to their spouses' RSA.

Existing Roth IRAs would be renamed RSAs and be made subject to the new rules for RSAs. Existing traditional and nondeductible IRAs could be converted into an RSA by taking the conversion amount into gross income, similar to a current-law Roth conversion. However, no income limit would apply to the ability to convert. Taxpayers who convert IRAs to RSAs before January 1, 2006, could include the conversion amount in income ratably over 4 years. Conversions made on or after January 1, 2006, would be included in income in the year of the conversion. Existing traditional or nondeductible IRAs that are not converted to RSAs could not accept any new contributions. New traditional IRAs could be created to accommodate rollovers from employer plans, but they could not accept any new individual contributions. Individuals wishing to roll an amount directly from an employer plan to an RSA could do so by taking the rollover amount (excluding basis) into gross income (i.e., “converting” the rollover, similar to a current law Roth conversion).

Amounts converted to an RSA from a traditional IRA or from an Employer Retirement Savings Account (ERSA) would be subject to a 5-year holding period. Distributions attributable to a conversion from a traditional IRA or ERSA (other than amounts attributable to a Roth-type account in an ERSA) prior to the end of the 5-year period starting with the year the conversion was made or, if earlier, the date on which the individual turns 58, becomes disabled, or dies would be subject to an additional 10 percent early distribution tax on the entire amount. The 5-year period is separately determined for each conversion contribution. To determine the amount attributable to a conversion, a distribution is treated as made in the following order: regular contributions; conversion contributions (on a first-in-first-out basis); earnings. To the extent a distribution is treated as made for a conversion contribution, it is treated as made first from the portion, if any, that was required to be included in gross income because of the conversion.

Individuals could contribute up to \$5,000 per year to their LSA, regardless of wage income. No income limits would apply to LSA contributions. Contributions would have to be in cash. The time period for which the contribution limit applies is the calendar year. Contributions would be nondeductible, but earnings would accumulate tax-free, and all distributions would be excluded from gross income, regardless of the individual’s age or use of the distribution. As with current law Roth IRAs, no minimum required distribution rules would apply to LSAs during the account owner’s lifetime.

Contribution limits would apply to all accounts held in an individual’s name, rather than to contributors. Thus, contributors could make annual contributions of up to \$5,000 each to the accounts of other individuals, but the aggregate of all contributions to all accounts held in a given individual’s name could not exceed \$5,000. The LSA contribution limit would be indexed for inflation.

Control over an account in a minor's name would be exercised exclusively for the benefit of the minor, until the minor reached the age of majority (determined under applicable state law), by the minor's parent or legal guardian acting in that capacity. Married individuals could roll amounts from their LSAs over to their spouses’ LSAs.

Taxpayers would be able to convert balances in Coverdell Education Savings Accounts (ESAs) and Section 529 Qualified Tuition Plans (QTPs) to LSA balances. All conversions must be made before January 1, 2006, and would be subject to the following limitations. An amount can be rolled into an individual's LSA from a QTP only if that individual was the beneficiary of the QTP or ESA as of December 31, 2003. The amount that can be rolled over to an LSA from an ESA is limited to the sum of the amount in the accounts as of December 31, 2003, plus any contributions to and earnings on the accounts in 2004. The amount that can be rolled over to any LSA from a QTP is limited to the sum of (i) the lesser of \$50,000 or the amount in the QTP as of December 31, 2003, plus (ii) any contributions and earnings to the QTP during 2004. Total rollovers to an individual's LSA attributable to 2004 contributions to the individual's ESAs and QTPs cannot exceed \$5,000 (plus any earnings on those contributions).

QTPs would continue to exist as separate types of accounts, but could be offered inside an LSA. For example, State agencies that administer QTPs could offer LSAs with the same investment options available under the QTP. The plan administrator would be freed from the additional reporting requirements of a QTP for investments in an LSA, but investors would be subject to the annual LSA contribution limit. Distributions for purposes other than education would not be subject to federal income-tax or penalties. However, States would be free to provide State tax incentives, and administrators would be free to provide investment incentives, for savings used for educational purposes.

The Saver's Credit would apply to contributions to an RSA but would not apply to contributions to an LSA.

Both LSAs and RSAs would become effective beginning on January 1, 2005.

**Revenue Estimate**

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-2009	2005-2014
(\$ in millions)							
0	3,949	8,192	5,488	2,798	685	21,112	5,558

## CONSOLIDATE EMPLOYER-BASED SAVINGS ACCOUNTS

### Current Law

Qualified Retirement Plans: Under Code section 401, employers may establish for the benefit of employees a retirement plan that may qualify for tax benefits, including a tax deduction to the employer for contributions, a tax deferral to the employee for elective contributions and their earnings, and a tax exemption for the fund established to pay benefits. To qualify for tax benefits, the plan must satisfy multiple requirements. Among the requirements, the plan may not discriminate in favor of highly-compensated employees (HCEs) with regard either to coverage or to amount or availability of contributions or benefits. The following cover some, but not all, of the defined-contribution plan rules.

*Contribution Limits.* The total annual contribution to a participant's account may not exceed the lesser of \$41,000 or 100 percent of compensation.

*General Nondiscrimination Requirement.* Qualified plans, both defined-benefit and defined-contribution, must comply with the Section 401(a)(4) prohibition on contributions or benefits that discriminate in favor of HCEs. Detailed regulations spell out the calculations required for satisfying this provision, including optional safe harbors and a general test for nondiscrimination.

*Contribution Tests.* In addition to the general nondiscrimination requirement, defined-contribution plans that have after-tax contributions or matching contributions are subject to the actual contribution percentage (ACP) test. This test measures the contribution rate to HCEs' accounts relative to the contribution rate to non-highly-compensated employees' (NHCEs') accounts. To satisfy the test, the ACP of HCEs generally cannot exceed the following limits: 200 percent of the NHCEs' ACP if the NHCEs' ACP is 2 percent or less; two percentage points over the NHCEs' ACP if the NHCEs' ACP is between 2 percent and 8 percent; or 125 percent of the NHCEs' ACP if the NHCEs' ACP is 8 percent or more.

Three "safe-harbor" designs are deemed to satisfy the ACP test automatically for employer matching contributions (up to 6 percent of compensation) that do not increase with an employee's rate of contributions or elective deferrals. In the first, vested employer matching contributions on behalf of NHCEs are equal to 100 percent of elective deferrals up to 3 percent of compensation, and 50 percent of elective deferrals between 3 and 5 percent of compensation. In the second, vested employer matching contributions follow an alternative matching formula such that the aggregate amount of matching contributions is no less than it would be under the first design. In the third, vested employer non-elective contributions are at least 3 percent of compensation made on behalf of all eligible NHCEs.

*Vesting.* In general, employer contributions must vest at least as quickly as under one of the following schedules. Under graded vesting, 20 percent of the benefit is vested after three years of service and an additional 20 percent vests with each additional year of service, so that the employee is fully vested after seven years of service. Under cliff vesting, the employee has no vested interest until five years of service has been completed, but is then fully vested. However, matching contributions must vest more quickly: under graded vesting, the first 20 percent must

vest after two years of service, so that the employee is fully vested after six years of service, and under cliff vesting, the employee becomes fully vested after three years of service.

*401(k) plans.* Private employers may establish 401(k) plans, which allow participants to choose to take compensation in the form of cash or a contribution to a defined-contribution plan (“elective deferral”). In addition to the rules applying to qualified defined-contribution plans, 401(k) plans are subject to additional requirements.

Annual deferrals under a 401(k) plan may not exceed \$13,000 in 2004 (increasing to \$15,000 by 2006). Participants aged 50 or over may make additional “catch-up” deferrals of up to \$3,000 (increasing to \$5,000 by 2006). Elective deferrals are immediately fully vested.

401(k) plans are subject to an actual deferral percentage (ADP) test, which generally measures employees’ elective-deferral rates. In applying the ADP test, the same numerical limits are used as under the ACP test. Three 401(k)-plan “safe-harbor” designs (similar to the safe-harbor designs for the ACP test described above) are deemed to satisfy the ADP test automatically.

*SIMPLE 401(k) plans.* Employers with 100 or fewer employees and no other retirement plan may establish SIMPLE 401(k) plans. Deferrals of SIMPLE participants may not exceed \$9,000 in 2004 (increasing to \$10,000 in 2005). SIMPLE participants aged 50 or over may make additional “catch-up” deferrals of up to \$1,500 (increasing to \$2,500 by 2006). All contributions are immediately fully vested. In lieu of the ADP test, SIMPLE plans are subject to special contribution requirements, including a lower annual elective deferral limit and either a matching contribution not exceeding 3 percent of compensation or non-elective contribution of 2 percent of compensation.<sup>4</sup>

*Thrift plans.* Employers may establish thrift plans under which participants may choose to make after-tax cash contributions. Such after-tax contributions, along with any matching contributions that an employer elects to make, are subject to the ACP test (without the availability of an ACP safe harbor). Employee contributions under a thrift plan are not subject to the \$13,000 limit that applies to employee pre-tax deferrals.

*Roth-treatment of contributions.* Effective after December 31, 2005, participants in 401(k) and 403(b) plans can elect Roth treatment for their contributions: That is, contributions would not be excluded from income and distributions would not be included in income. Roth contributions must be accounted for in a separate account. There are no required minimum distributions during an employee’s lifetime, but heirs, other than a spouse, are subject to required minimum distributions.

*Salary reduction simplified employee pensions (SARSEPs).* Employees can elect to have contributions made to a SARSEP or to receive the amount in cash. The amount the employee elects to have contributed to the SARSEP is not currently includible in income and is limited to the dollar limit applicable to employee deferrals in a 401(k) plan. SARSEPs are available only for employers who had 25 or fewer eligible employees at all times during the prior taxable year

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<sup>4</sup> Employer contributions and employee deferrals may be made to SIMPLE IRAs under rules very similar to those applicable to SIMPLE 401(k) plans.

and are subject to a special nondiscrimination test. The rules permitting SARSEPs were repealed in 1996, but employee deferral contributions can still be made to SARSEPs that were established prior to January 1, 1997.

**403(b) plans:** Section 501(c)(3) organizations and public schools may establish tax-sheltered annuity plans, also called 403(b) plans. In general these plans are subject to different rules than qualified plans under section 401. Benefits may be provided through the purchase of annuities or contributions to a custodial account invested in mutual funds. Contribution limits (including catch-ups), deferral limits, and minimum distribution rules are generally the same as for 401(k) plans. However, certain employees with 15 years of service may defer additional amounts according to a complicated three-part formula. Some 403(b) plans are subject to some nondiscrimination rules.

**Governmental 457 plans:** State and local governments may establish Section 457 plans.<sup>5</sup> In general, these plans are subject to different rules than qualified plans that are defined under section 401. Participant contributions are tax-deferred until substantially vested, and plan earnings are tax-deferred until withdrawal, due to the exemption enjoyed by state and local governments. Participant elective contributions may not exceed the lesser of 100 percent of compensation or \$13,000 in 2004 (increasing to \$15,000 by 2006). However, participants may make additional contributions of up to twice the standard amount in the last three years before normal retirement age. Participants aged 50 or over may make additional “catch-up” contributions of up to \$3,000 (increasing to \$5,000 by 2006).

#### Reasons for Change

The rules covering employer retirement plans are among the lengthiest and most complicated sections of the tax code and associated regulations. The extreme complexity imposes substantial compliance, administrative, and enforcement costs on employers, participants, and the government (and hence, taxpayers in general). Moreover, because employer sponsorship of a retirement plan is voluntary, the complexity discourages many employers from offering a plan at all. This is especially true of the small employers who together employ about two-fifths of American workers. Complexity is often cited as a reason the coverage rate under an employer retirement plan has not grown above about 50 percent overall, and has remained under 25 percent among employees of small firms. Reducing unnecessary complexity in the employer plan area would save significant compliance costs and would encourage additional coverage and retirement saving.

#### Proposal

The proposal would consolidate those types of defined-contribution accounts that permit employee deferrals or employee after-tax contributions and simplify defined-contribution plan qualification rules.

The proposal would become effective for years beginning after December 31, 2004.

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<sup>5</sup> Tax-exempt organizations are permitted to establish section 457 plans, but such plans are not funded arrangements and are generally limited to management or highly compensated employees.

**Consolidate 401(k), SIMPLE 401(k), Thrift, 403(b), and Governmental 457 plans, as well as SIMPLE IRAs and SARSEPs, into Employer Retirement Savings Accounts (ERSAs), which would be available to all employers and have simplified qualification requirements.**

ERSAs would follow the existing rules for 401(k) plans, subject to the plan qualification simplifications described below. Thus, employees could defer wages of up to \$13,000 annually (increasing to \$15,000 by 2006), with employees aged 50 and older able to defer an additional \$3,000 (increasing to \$5,000 by 2006). The maximum total contribution (including employer contributions) to ERSAs would be the lesser of 100 percent of compensation or \$41,000. The taxability of contributions and distributions from an ERSA would be the same as contributions and distributions from the plans that the ERSA would be replacing. Thus, contributions could be pre-tax deferrals or after-tax employee contributions or Roth contributions, depending on the design of the plan. Distributions of Roth and non-Roth after-tax employee contributions and qualified distributions of earnings on Roth contributions would not be included in income. All other distributions would be included in the participants' income.

Existing 401(k) and Thrift plans would be renamed ERSAs and could continue to operate as before, subject to the simplification described below. Existing SIMPLE 401(k) plans, SIMPLE IRAs, SARSEPs, 403(b) plans, and governmental 457 plans could be renamed ERSAs and be subject to ERSA rules, or could continue to be held separately, but if held separately could not accept any new contributions after December 31, 2005, with a special transition for collectively bargained plans and plans sponsored by state and local governments.

*Special Rule for Small Employers.* Employers that had 10 or fewer employees making at least \$5,000 during the prior year would be able to fund an ERSA by contributing to a custodial account, similar to a current-law IRA, provided the employer's contributions satisfy the design-based ERSA safe harbor described below. This custodial account would provide annual reporting relief for small employers as well as relief from most of the ERISA fiduciary rules under circumstances similar to the fiduciary relief currently provided to sponsors of SIMPLE IRAs.

*ERSA Nondiscrimination Testing.* The following single test would apply for satisfying the nondiscrimination requirements with respect to contributions for ERSAs: the average contribution percentage of HCEs could not exceed 200 percent of NHCEs' percentage if the NHCEs' average contribution percentage were 6 percent or less. In cases in which the NHCEs' average contribution percentage exceeded 6 percent, the goal of increasing contributions among NHCEs would be deemed satisfied, and no nondiscrimination testing would apply. For this purpose, "contribution percentage" would be calculated for each employee as the sum of all employee and employer contributions divided by the employee's compensation. The ACP and ADP tests would be repealed. Plans sponsored by state and local governments would not be subject to this test. A plan sponsored by a section 501(c)(3) organization would not be subject to this nondiscrimination test (unless the plan permits after-tax or matching contributions) but would be required to permit all employees of the organization to participate.

*ERSA Safe Harbor.* The design-based safe harbor described below would be sufficient to satisfy the nondiscrimination test for ERSAs described above. The design of the plan must be such that all eligible NHCEs are eligible to receive fully vested employer contributions (including matching or non-elective contributions, but not including employee elective deferrals or after-tax contributions) of at least 3 percent of compensation. To the extent that the employer contributions of 3 percent of compensation for NHCEs are matching contributions rather than non-elective contributions, the match formula must be one of two qualifying formulas. The first formula would be a 50 percent employer match for the elective contributions of the employee up to 6 percent of the employee's compensation. The second would be any alternative formula such that the rate of an employer's matching contribution does not increase as the rate of an employee's elective contributions increases, and the aggregate amount of matching contributions at such rate of elective contribution is at least equal to the aggregate amount of matching contributions which would be made if matching contributions were made on the basis of the percentages described in the first formula. In addition, the rate of matching contribution with respect to an HCE at any rate of elective contribution cannot be greater than that with respect to an NHCE.

*Roth ERSAs.* The effective date for Roth contributions to ERSAs would be after December 31, 2004 (changed from after December 31, 2005, under current law).

**Revenue Estimate**

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
(\$'s in millions)							
0	-214	-318	-337	-358	-380	-1,607	-11,763