MEMO# 11136

July 28, 1999

HOUSE PASSES FINANCIAL FREEDOM ACT OF 1999

[11136] July 28, 1999 TO: PENSION COMMITTEE No. 46-99 PENSION OPERATIONS ADVISORY COMMITTEE No. 36-99 RE: HOUSE PASSES FINANCIAL FREEDOM ACT OF 1999 ____ The House recently passed H.R. 2488, the “Financial Freedom Act of 1999” by a vote of 228 to 208, mostly along party lines. H.R. 2488 contains major tax, pension and education proposals. Specifically, H.R. 2488 includes many provisions strongly supported by the Institute including: increased contribution limits for pension plans, portability, elimination of the 25% of compensation rule, catch- ups, modification of the top-heavy rules, increase in the Roth IRA conversion limit and increase in the Education IRA contribution limit. President Clinton has indicated that he intends to veto this bill. We have included relevant excerpts of the legislative language and the Report of the Committee on Ways and Means (the "Report") as attachments. The effective date for all proposals is January 1, 2001, except where otherwise noted. Please note that section 1504 of H.R. 2488 would increase the withholding rate for nonperiodic distributions from 10 to 15 percent for distributions made after December 31, 1999. H.R. 2488 contains the following proposals: I. Pension proposals (Title XII) Subtitle A. Expanding Coverage A. Increased contribution and benefit limits: Section 1201 of the bill would increase section 415’s limitation on benefits to $40,000, indexed in $1,000 increments. (Section 1222 eliminates the 25% of compensation rule, as described in subsection B of subtitle B below.) In addition, Section 1201 would increase section 401(a)(17)’s limit on the amount of compensation that may be taken into account under a plan for determining benefits to $200,000, indexed in $5,000 increments. The bill would increase the section 402(g) limit, beginning in 2001, in $1,000 increments until the limit reaches $15,000 in 2005, i.e., the limit in 2001 would be $11,000, $12,000 in 2002, etc, until it reaches $15,000 in 2005. The contribution limit for section 457 plans would conform to the 402(g) limit, i.e., the limit in 2001 would be $11,000, $12,000 in 2002, etc. Finally, the bill would increase the SIMPLE plan contribution limit in $1,000 increments until it reached $10,000 in 2004, i.e., the SIMPLE plan contribution limit would be $7,000 in 2001 and $8,000 in 2002 until it reaches $10,000 in 2004. The 402(g), 457 plan and SIMPLE plan limits would be indexed in $500 increments. See pages 127-132 of the bill and 288-291 of the Report. B. Plan loans available to subchapter S shareholders, partners and sole proprietors: Section 1202 of the bill would extend present law with respect to plan loans to participants to subchapter S shareholders, partners and sole proprietors. See pages 132-133 of the bill and 291-292 of the Report. 2C. Modification of top-heavy rules: Section 1203 of the bill would provide that a plan that satisfies the design-based safe harbor under section 401(k)(12) and the matching contributions requirements under section 401(m)(11) would not be deemed top-heavy. The bill would also provide that matching or nonelective contributions provided under such a plan could be taken into account for purposes of

minimum contributions under the top-heavy rules. Further, distributions made during the year ending on the date the top-heavy determination is made would be taken into account for purposes of the rule. The bill would apply the current 5-year rule to in-service distributions. The bill would define “key employee” as an employee earning more than $150,000 and would repeal the top- 10 owner key employee category. In addition, the bill would repeal the 4-year look-back rule for determining key employee status and provide that an employee is deemed a key employee only if he or she is a key employee during the current plan year. See pages 133-134 of the bill and 292-296 of the Report. D. Elective deferrals not counted toward employer deduction limit: Section 1204 of the bill would modify section 404 to provide that employee elective deferrals would not be taken into account for purposes of the deduction limits. See pages 134-135 of the bill and 296-297 of the Report. E. Repeal of coordination of contribution limits for 457 plans: Section 1205 of the bill would repeal the rules requiring coordination of contributions to other types of plans with contributions to 457 plans for purposes of the 457 plan contribution limit. See pages 135 of the bill and 298-299 of the Report. F. Elimination of user fees for determination letter requests for small employers: Section 1206 of the bill would eliminate the user fee charged by the IRS for any determination letter regarding the qualified status of a plan for small employers (employers with 100 or fewer employees). See pages 135 of the bill and 299-300 of the Report. G. Modification of definition of compensation for purposes of deduction limits: Section 1207 would modify section 404's definition of compensation to include elective deferral contributions. See pages 135-136 of the bill and 300-301 of the Report. H. “Plus” Accounts: Section 1208 of the bill would permit 401(k) plans and 403(b) arrangements to sponsor “qualified plus contribution programs,” in which a participant could designate all or a portion of his or her elective deferrals as designated plus contributions, i.e., after-tax contributions. Plans that sponsor plus programs would be required to establish separate accounts and maintain separate recordkeeping for plus contributions and applicable earnings. Plus contributions would be subject to the 402(g) limit on contributions. The bill would permit rollover of plus contributions to another qualified plus contribution account or a Roth IRA. Qualified distributions from a plus account would not be includible in income. The requirements applicable to qualified distributions from plus account would be the same as those for qualified distributions from Roth IRAs. The 5- year period applicable to qualified plus contributions would begin with the earlier of (1) the first taxable year for which the participant made a designated plus contribution under the plan; or (2) if the participant make a rollover contribution to the designated plus account, the first taxable year for which the participant made a designated plus contribution to the previously established account. The bill would subject plus contributions to nondiscrimination testing. See pages 136-139 of the bill and 301-303 of the Report. Subtitle B. Enhancing Fairness for Women A. Catch-up contributions: Section 1221 of the bill would permit participants aged 50 and older to make additional contributions, i.e. catch-up contributions, to 401(k), 403(b), 457 or SIMPLE plans. 3The contribution limit for these individuals would be increased in $1,000 increments each year beginning in 2001 until the contribution limit is increased by $5,000 in 2005. The $5,000 limit would be indexed in $500 increments. The catch-up rule would not apply during a participant’s last three years before retirement in a 457 plan. In such circumstances, the regularly applicable dollar limit is doubled. See pages 139-141 of the bill and 304-305 of the Report. B. Elimination of the 25% of compensation rule: Section 1222 would eliminate section 415’s 25% of compensation limitation on annual contributions to defined contribution plans. In addition, the provision would repeal the exclusion allowance for 403(b)s and increase the 33 1/3% of compensation limit on deferrals under a 457 plan to 100% of compensation. See pages 141-143 of the bill and 305-307 of the Report. C. Faster vesting of employer contributions: Section 1223 of the bill would apply faster vesting schedules to employer matching contributions as follows: 3 year cliff or 6 year graded. See pages 143-144 of the bill and 307-308 of the Report. D. Simplification and modification of the minimum required distribution rules: Section 1224 of the bill would modify the current minimum required distribution (“MRD”) rules. The proposal would apply the MRD rules currently applicable to distributions where the participant has died before minimum distributions have begun to all post-death distributions, i.e., if a participant dies before his or her entire interest has been distributed, the remaining interest must be distributed within 5 years of death or within one year of date of death and be paid over the life or life expectancy of a designated beneficiary. The bill would continue to permit surviving spouses to begin distributions when the spouse turns 70 1/2. The bill would apply to future distributions for participants in MRD status and would permit the selection of a new beneficiary and election of a new method of calculating life expectancy. The bill would reduce the excise tax on failures to satisfy the MRD rules to 10% from 50%. The bill would direct the Treasury Department to update, simplify and finalize the MRD regulations. Specifically, the bill would require Treasury to revise its current regulations to reflect the current life expectancies and revise the MRD methods so that under reasonable assumptions, the amount of the required distribution does not decrease over a participant’s life expectancy. Finally, section 1239 of the bill would apply the MRD rules to 457 plans, thereby repealing the special MRD rules currently applicable to 457 plans. See pages 144-145 and 156-157 of the bill and 308-311 of the Report. E. Clarification of division of 457 plan assets in a divorce: Section 1225 would apply the tax rules for qualified plan rules pursuant to a qualified domestic relations order (“QDRO”) (section 402(e)(1)(A)) to distributions made pursuant to a QDRO for a 457 plan. In addition, the bill would provide that a 457 plan would not be treated as violating the restrictions on distributions from such plans due to payments to an alternate payee under a QDRO. See pages 146 of the bill and 311-312 of the Report. Subtitle C. Increasing Portability for Participants A. Portability: Sections 1231- 1239 would facilitate increased portability among various types of plans and IRAs. Specifically, the bill would allow rollovers to and from 401(k)s, 403(b)s, 457s and IRAs. The portability provisions would be voluntary, i.e., an employer would not be required to accept rollovers of different plan types to its plan. The direct rollover and withholding rules would apply to distributions from a 457 plan and such plans would be required to provide written notification regarding eligible rollover distributions. The bill would require modification of the 402(f) notice regarding rollovers to include a description of the provisions under which distributions from the plan that are rolled to another plan may be subject to different restrictions and tax consequences. 4The bill would provide for certain exceptions to the general rule that the rollover amounts take on the characteristics of the new plan, i.e., distribution rules. First, a distribution from a qualified plan would not be eligible for capital gains or averaging treatment if there was a rollover to the plan that would have not been permitted under current law. Therefore, in order to preserve capital gains and averaging treatment for rollover amounts, the rollover would have to be made to a “conduit” IRA and then rolled back to a qualified plan. Second, amounts distributed from a section 457 plan would be subject to the early withdrawal tax to the extent the distributions consist of amounts attributable to rollovers from another type of plan. Section 457 plans would be required to account separately for such amounts. Section 1239 would provide that benefits in section 457 plans are includible in income when paid. Section 1231 would expand the spousal rollover rules to permit surviving spouses to roll over distributions to a qualified plan, 403(b) or governmental 457 plan in which the spouse participates. Section 1233 would limit rollovers of IRA contributions to 401(k)s, 403(b)s and 457s to those amounts attributable to deductible contributions and earnings. Section 1234 would permit rollovers of after-tax contributions to plans to qualified plans and IRAs. The bill would require that rollovers of after-tax contributions between qualified plans be direct rollovers. In such circumstances, the receiving plan would be required to separately account for such after-tax amounts and applicable earnings. For rollovers of IRA contributions to plans, the bill would provide the following ordering rule: deductible contributions and earnings are deemed to be distributed from the IRA before after- tax contributions. The accompanying description of the bill provides for Treasury to prescribe regulations necessary to carry out the portability provisions, including reporting requirements and mechanisms to address mistakes relating to rollovers. In addition, the description anticipates that the IRS will develop a form to assist taxpayers who roll after-tax contributions to an IRA to keep track of their contributions. See pages 146-152 and 156-157 of the bill and 312-315 of the Report. B. Waiver of 60-day rule: Section 1234 would permit the Secretary of the Treasury to waive the 60-day rollover rule if failure to do so would be “against equity or good conscience, including casualty, disaster or other events beyond the reasonable control of the individual.... ” See pages 152 of the bill and 316 of the Report. C. Modification of section 411(d)(6): Section 1235 would modify the 411(d)(6) forms of distributions rule. Specifically, the bill would provide that a defined contribution plan to which benefits are transferred would not be treated as reducing a participant’s or beneficiary’s accrued benefit even though it does not provide all of the forms of distribution previously available under the transferor plan if (1) the benefits are transferred via a direct transfer or the plan results from a merger or other consequences that has the effect of a direct transfer, i.e., consolidation of benefits attributable to different employers within a multi-employer plan; (2) both the transferor and transferee plan authorize the transfer; (3) the transfer is made pursuant to a voluntary election by participant; (4) the voluntary election was made subsequent to the participant receiving notice regarding the consequences of the transfer; (5) if the transferor plan provides for an annuity as the normal form of distribution, the transfer is made with the consent of the participant’s spouse; and (5) the transferee plan allows the participant to receive a lump sum distribution. The bill would also provide that the elimination of a form of distribution would not violate section 411(d)(6) if (1) a single sum distribution is available to the participant; and (2) the single sum payment is based on the same or greater portion of the participant’s account as the form of 5distribution being eliminated. The bill would also permit the Secretary to issue regulations providing that section 411(d)(6) would not apply to any plan amendment that does not adversely affect the rights of participants in a material manner. See pages 152-154 of the bill and 316-318 of the Report. D. Rationalization of restrictions on distribution rules: Section 1236 would modify the distribution restrictions applicable to 401(k)s, 403(b)s and 457s to allow distributions to occur upon severance from employment rather than separation from service. In addition, the bill would repeal the special rules for a distribution from a 401(k) plan based upon a corporation’s disposition of its assets or a subsidiary. See pages 154-155 of the bill and 318-319 of the Report. E. Purchase of Service Credits in 457 Plans: Section 1237 would permit participants in a 457 plan to exclude from income trustee-to-trustee transfers of 457 or 403(b) amounts to a governmental defined benefit plan if the transfer is used (1) to purchase permissive service credits under the plan; or (2) to repay contributions and earnings related to an amount previously refunded under a forfeiture of service credit under the plan. See pages 155 of the bill and 319-320 of the Report. 6F. Employers may disregard rollovers for purpose of cash-out rule: Section 1238 would permit a plan to provide that the participant’s nonforfeitable accrued benefit, for purposes of the $5,000 cash-out rule, is determined without regard to the portion of the benefit attributable to rollover contributions. See pages 155-156 of the bill and 320-321 of the Report. Subtitle D. Strengthening Pension Security and Enforcement Sections 1241-1244 of the bill include miscellaneous defined benefit provisions, including repeal of the 150% of current liability funding limit, extension of the missing participants program to multiempoyer plans, excise tax relief for sound pension funding and excise tax on failure to provide notice regarding significant reduction of future benefit accruals. See pages 157-161 of the bill and 321-327 of the Report. Subtitle E. Reducing Regulatory Burdens A. Repeal of the Multiple Use Test: Section 1251 would repeal the multiple use test under section 401(m). See pages 161 of the bill and 327-328 of the Report. B. Flexibility in nondiscrimination and line of business rules: Section 1253 would direct the Secretary to modify on or before December 31, 2000, the existing regulations under section 401(a)(4) and section 414(r) in order to expand, to the extent deemed appropriate, the ability of a pension plan to demonstrate compliance with the nondiscrimination and line of business requirements based upon the facts and circumstances of the design and operation of the plan, even though the plan is unable to satisfy the mechanical tests. See pages 162-163 of the bill and 328-329 of the Report. C. Notice and consent period regarding distributions: Section 1255 would modify section 417(a)(6)'s distribution notice requirement to provide that plan must provide the notice no less than 30 days and no more than 6 months (instead of 90 days) before the date distribution commences. See pages 163 of the bill and 332-333 of the Report. D. Repeal of the transition rule relating to certain highly compensated employees: Section 1256 would repeal the special definition of highly compensated employees under the Tax Reform Act of 1986 (for an employer incorporated on December 15, 1924). See pages 163-164 of the bill and 333-334 of the Report. E. Employees of tax-exempt entities: Section 1257 would direct the Treasury Department to revise its regulations under section 410(b) to provide that employees of a tax-exempt charitable organization who are eligible to make salary reduction contributions under a 403(b) annuity may be treated as excludable employees for purposes of testing a 401(k) plan or a section 401(m) plan that is provided under the same arrangement as the section 401(k) of the employer if (1) no employee of such a tax-exempt organization is eligible to participate in the section 401(k) or 401(m) plan, and (2) 95% of the employees who are not employees of the charitable employer are eligible to participate in such 401(k) or 401(m) plan. The effective date of this proposal is January 1, 1997, the same effective date as the Small Business Job Protection Act of 1996. See pages 164 of the bill and 334-335 of the Report. F. Clarification of treatment of employer-provided retirement advice: Section 1258 would permit participants and their spouses to exclude from income qualified employer-provided retirement planning services. The exclusion would not apply to highly compensated employees unless the services are provided on substantially the same terms to each member of the group of employees 7normally provided education and information on the employer's pension plan. See pages 164 of the bill and 335-336 of the Report. G. Plan Amendments: Section 1259 of the bill would provide that plan amendments required as a result of the bill would not be required to be made before the last day of the first plan year beginning on or after January 1, 2003. For government plans, the amendment dates would be extended to the first plan year beginning on or after January 1, 2005. See pages 164-165 of the bill and 336 of the Report. H. Model plans for small employers: Section 1260 would direct the Secretary to issue at least one model defined contribution plan document and at least one model defined benefit plan document that would fit the needs of small businesses and satisfy the requirements of section 401(a) by December 31, 2000. To the extent that the requirements of section 401(a) are modified after the issuance of the model plans, the Secretary would be directed to, in a timely manner, issue model amendments that will cause a model plan adopting the plan amendments to be treated as meeting the requirements of section 401(a). See pages 165-166 of the bill and 337-338 of the Report. I. Simplified reporting for small employers: Section 1261 would direct the Secretary to provide for the filing of a simplified annual return, similar to Form 5500-EZ, for a plan that (1) covers less than 25 employees on the first day of the plan year; (2) is not aggregated with another plan in order to satisfy the minimum coverage requirements of section 410(b); (3) is maintained by an employer that is not a member of a related group of employers; and (4) is maintained by an employer that does not receive the services of leased employees. Section 1262 would be effective upon enactment. See pages 166 of the bill and 336-337 of the Report. J. Improvement of Employee Plans Compliance Resolution System (EPCRS): Section 1262 would direct the Secretary to update and improve the EPCRS by (1) increasing the awareness and knowledge of small employers concerning the availability and use of the program; (2) taking into account special concerns and circumstances that small employers face with respect to compliance and correction of compliance failures; (3) extending the duration of the self-correction period under the Administrative Policy Regarding Self-Correction for significant compliance failures; (4) expanding the availability to correct insignificant compliance failures under the Administrative Policy Regarding Self-Correction during audit; and (5) assuring that any tax, penalty or sanction that is imposed by reason of a compliance failure is not excessive and bears a reasonable relationship to the nature, extent and severity of the failure. See pages 166 of the bill and 338-339 of the Report. K. Treatment of Multiemployer Plans Under Code Section 415: Section 1263 of the bill would provide that the 100 percent of compensation limitation in Code section 415(b)(1) does not apply to multiemployer plans. Current law only exempts governmental plans from this limitation. See pages 166-167 of the bill. II. IRAs A. Conversions to Roth IRAs (Title I): Section 113 of the bill would raise the income limitation for married couples filing joint returns from $100,000 to $160,000 for taxable years beginning after December 31, 1999. The limit for individuals would remain at $100,000. See pages 16 of the bill and 152-153 of the Report. B. Technical Correction Concerning Roth IRA Distributions (Title XVI): Section 1603(a) of the bill would clarify that Code section 3405, which generally requires payors to withhold 10 percent of any 8distribution from an IRA (unless the payee affirmatively elects not to have any withholding), does not apply to Roth IRAs. See pages 209-210 of the bill and 394 of the Report. C. Technical Correction Concerning IRAs for Nonworking Spouses (Title XVI): The Small Business Job Protection Act of 1996 expanded the IRA deduction for nonworking spouses. In certain cases, however, the nonworking spouse could make IRA contributions in excess of the couples' combined earned income. Under section 1604(c) of the bill, such contributions would not be permitted to exceed the couples' combined earned income. The provision would be effective for taxable years beginning after December 31, 1999. See pages 210 of the bill and 395 of the Report. III. Education IRAs (Title IV) (See pages 29-33 of the bill and 169-175, 178 of the Report). A. Increased Contribution Limit: Section 401(a) of the bill would increase the annual contribution limit to an Education IRA from $500 per designated beneficiary to $2,000. B. Expansion of Qualified Education Expenses: Section 401(b) of the bill would expand the definition of "qualified education expenses" for which account distributions may be used to include qualified elementary and secondary education expenses, as well as certain homeschooling expenses. The definition is also further modified in section 402(e) of the bill. C. Special Needs Beneficiaries: Under current law, contributions to an Education IRA are not permitted once the beneficiary reaches age 18. Section 401(c) of the bill would eliminate this age limitation for beneficiaries with "special needs." D. Entities Eligible to Contribute to Accounts: Section 401(d) of the bill would clarify that corporate and nonprofit entities may contribute to Education IRAs. Such entities would not be subject to the income limitations applicable to individual contributors. E. Extension of Time To Contribute and To Remove Excess: Section 401(e) of the bill would extend the time by which contributions must be made to an Education IRA for a given taxable year from December 31st to April 15th, adopting language similar to that applicable to traditional IRAs. The bill would also provide that excess contributions made for a taxable year may be removed up until June 1st of the year following that year without incurring a 10-percent penalty tax for the distribution. F. Coordination with HOPE and Lifetime Learning Credits and Qualified Tuition Programs: Section 401(f) of the bill would alter the manner in which Education IRA distributions are coordinated with credits received under the HOPE and Lifetime Learning Credits programs and any qualified tuition programs in a given year. Specifically, the bill would allow an individual to claim a HOPE or Lifetime Learning Credit and take a qualified distribution from an Education IRA on behalf of the same student in the same tax year, as long as the credit and distribution are used for different educational expenses. Similarly, the bill would permit contributions to be made to both an Education IRA and to a qualified tuition program in the same year. G. Education IRAs Renamed “Education Savings Accounts”: Effective upon the date of the bill’s enactment, section 401(g) of the bill would change the name of Education IRAs to “Education Savings Accounts.” H. Effective Dates: Modifications to Education IRAs would become effective for taxable years beginning after December 31, 2000. However, the definitional change to the term “qualified higher 9education expenses” (which would also apply to qualified tuition programs) would become effective for taxable years beginning after December 31, 1999. IV. Qualified Tuition Programs (Title IV) (See pages 33-36 of the bill and 175-178 of the Report). A. Expansion to Private Educational Institutions: Section 402(a) of the bill would expand the qualified state tuition program to enable private educational institutions to establish such programs under Code section 529. The bill would require, however, that programs established by private institutions be in the form of tuition credit or certificate programs. As under the current rule, only qualified state institutions would be permitted to establish “savings account plans.” B. Exclusion from Gross Income: Section 402(b) of the bill would provide that distributions made in taxable years after December 31, 2000 used for qualified higher education expenses are excludible from gross income. However, with respect to distributions from programs established by eligible private educational institutions, the provision excluding distributions from gross income would become effective January 1, 2004. C. Rollovers and Designated Beneficiary Changes: Section 402(c) of the bill would clarify that the rollover of credits or other amounts between qualified tuition programs for the same beneficiary are permissible if limited to one in each 1-year period. Furthermore, section 402(d) would provide that first cousins are considered a “member of the family” for purposes of designated beneficiary changes permitted under section 529(c)(3)(C). This “member of the family” definition would also apply to Education IRAs. D. Coordination with HOPE and Lifetime Learning Credits and Education IRAs: Section 402(b)(1) of the bill would provide for the coordination of qualified tuition programs and the other education savings programs in a manner similar to that of Education IRAs. 10 V. Medical Savings Accounts (MSAs) (Title V) (See pages 41-43 of the bill and 187-192 of the Report.) A. Expanded Availability of MSAs: Current law limits the availability of MSAs to employees of small employers and self-employed individuals, and also caps the total number of taxpayers that may contribute to MSAs. Section 503 of the bill would expand the availability of MSAs to include all employees covered under a high deductible plan of the employer. The definition of high deductible health plan would also be modified by decreasing the threshold for the annual deductible for both self-only and family-coverage health plans. In addition, the bill would eliminate the limit on the total number of taxpayers that may participate in MSAs and would permit the offering of MSAs as part of cafeteria plans. B. Increase in Contribution Limits: Section 503(c) of the bill would increase the amount of deductible contributions to 100 percent of the deductible amount under a high deductible health plan. Current law limits the amount of deductible contributions to an MSA to 65 percent of the deductible under the health plan for self-only covered individuals and 75 percent of the deductible for an individual with family coverage. The bill would also allow employees to make deductible contributions to MSAs even if the employer contributed to the MSA during the same taxable year. C. MSAs Made Permanent: MSAs would no longer be a pilot program under the bill. VI. Miscellaneous Provisions A. Elective Withholding Rate for Nonperiodic Distributions from Deferred Compensation Plans (Title XV): Section 1504 of the bill would increase the withholding rate for nonperiodic distributions from 10 percent to 15 percent, effective for distributions after December 31, 1999. See pages 200 of the bill and

379-381 of the Report. B. Excess Pension Assets Used for Retiree Health Benefits (Title XV): Section 1507 of the bill would extend the availability of qualified transfers of excess pension assets of a defined benefit plan to health benefit accounts of such plans from December 31, 2000 to September 30, 2009. The bill would also replace the minimum benefit requirement, which requires the provision of a minimum level of health benefits for 5 taxable years beginning with the taxable year of transfer, with the minimum cost requirement, which would require the provision of a minimum dollar level of retiree health expenditures for the same period. See pages 206-207 of the bill and 386-389 of the Report. Thomas Kim Kathryn Ricard Assistant Counsel Assistant Counsel Attachments

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