MEMO# 12385

July 25, 2000

HOUSE PASSES H.R. 1102, THE ?COMPREHENSIVE RETIREMENT SECURITY AND PENSION REFORM ACT OF 2000?

[12385] July 25, 2000 TO: PENSION COMMITTEE No. 53-00 PENSION OPERATIONS ADVISORY COMMITTEE No. 53-00 RE: HOUSE PASSES H.R. 1102, THE "COMPREHENSIVE RETIREMENT SECURITY AND PENSION REFORM ACT OF 2000" On July 19, 2000, the House passed, by a vote of 401 to 25, H.R. 1102, the "Comprehensive Retirement Security and Pension Reform Act of 2000" (the "Bill"). Chairman Roth (R-DE) of the Senate Finance Committee has indicated that he will seek Senate consideration of the Bill later this year. The Bill contains substantial pension and IRA provisions, many of which have been advocated by the Institute. Significant provisions include those that would increase contribution limits to 401(k), 403(b), 457, and SIMPLE plans and IRAs, permit "catch-up" contributions to IRAs and employer- sponsored plans for individuals 50 and older, permit after-tax "Plus" contributions to 401(k) and 403(b) plans, enhance portability, and modify current top-heavy rules. The Bill, however, does not include a number of pension-related provisions that had appeared in H.R. 2488, the "Taxpayer Refund and Relief Act of 1999" ("H.R. 2488") — the comprehensive tax bill vetoed by the President last year.1 Additionally, the Bill differs in a number of respects from the pension provisions in H.R. 3081, the "Minimum Wage Bill," introduced by Representative Lazio (R-NY) last year.2 1 Most notably, the Bill would not raise the Roth IRA income eligibility limitations. Other provisions in H.R. 2488 that do not appear in the Bill are those that would expand education savings programs, extend the authorization period for IRS user fees, increase the elective withholding rate for nonperiodic distributions from deferred compensation plans, extend the availability of transfers of excess defined benefit plan assets for retiree health benefits, extend PBGC's "missing participants" program to defined contribution plans, modify other PBGC-related rules, and modify the effective date of a provision in the Taxpayer Relief Act of 1997 that excludes certain elective deferrals from plan investment limitations regarding employer securities or real property. See Institute Memorandum to Pension Members No. 31-99, Tax Committee No. 21-99, Transfer Agent Advisory Committee No. 53-99, Operations Committee No. 32-99 and Investment Advisers Committee No. 10-99, dated August 13, 1999. Additional differences between the Bill and H.R. 2488 are identified in footnotes throughout this memorandum. 2 H.R. 3081 contained similar pension provisions as the Bill, but did not include IRA-expansion proposals. H.R. 3081 also contained a number of additional provisions that do not appear in the Bill. These provisions include those relating to periodic pension benefits statements, civil penalties for fiduciary breach, technical corrections to the Saver Act, model language for spousal consents and QDROs, elimination of ERISA double

jeopardy, annual report dissemination, expansion of excess benefit plans, and benefit suspension notices. See Institute Memorandum to Pension Committee No. 60-99 and Pension Operations Advisory Committee No. 47-99, dated October 19, 1999. 2Effective dates are discussed below; generally, provisions in the Bill are effective after December 31, 2000. The text of the Bill, a description of the Bill prepared by the Joint Committee on Taxation ("Description"), a 1-page description of the House Ways and Means Committee's amendment to the Bill ("Bill Amendment"),3 and an estimate of the Bill's revenue effects also prepared by the Joint Tax Committee are attached. I. Individual Retirement Accounts (Title I) A. Increase in Annual Contribution Limit. The Bill would increase the current $2,000 annual contribution limit to IRAs and Roth IRAs as follows: $3,000 in 2001; $4,000 in 2002; $5,000 in 2003 and thereafter. Beginning in 2004, the limit would be indexed for inflation in $500 increments. Bill Section 101; Description p. 2-4.4 B. Catch-Up Contributions to IRAs by Individuals Age 50 or Over. Effective 2001, the Bill would permit individuals who have attained age 50 to make IRA contributions up to $5,000 (before application of the AGI phase-out limits).5 Beginning in 2004, the maximum contribution amount would be indexed in $500 increments, conforming to the general IRA contribution limit. (See also Bill Section 301 for similar catch-up contributions to employer-sponsored retirement plans). Bill Section 101; Description p. 2-4.6 II. Expanding Pension Coverage (Title II) A. Increased Contribution and Benefit Limits. The Bill would increase Code section 415's limitation on annual additions to defined contribution plans from $30,000 to $40,000; this amount would be indexed for inflation in $1,000 increments (see also Bill Section 302, which would increase the "25 percent of compensation" rule to 100 percent of compensation). The Bill 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 elective deferral limitation under section 402(g), beginning in 2001, in annual increments of $1,000 until the limit reaches $15,000 in 2005. Thus, the limit would be $11,000 in 2001, $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 would be $11,000 in 2001, $12,000 in 2002, etc., 3 The House Ways and Means Committee modified the Bill to (i) make catch-up contributions subject to nondiscrimination requirements (see Bill Section 301), and (ii) direct the Treasury Department to prepare a report on the effects of conversions of traditional defined benefit plans to cash balance plans (see Bill Section 504). These modifications are explained in the Bill Amendment and reflected in the attached text of the Bill. 4 The Bill provides for a faster phase-in of contribution limit increases than the IRA provisions contained in H.R. 2488. Additionally, the increment at which the contribution limit would be indexed was changed from $100 to $500. Furthermore, unlike H.R. 2488, the Bill does not contain provisions that would (i) increase the income eligibility limits for Roth IRA contributions and conversions (as noted above), (ii) allow contributions to IRAs as part of a separate account within an employer-sponsored retirement plan, or (iii) exclude qualified charitable distributions from IRAs from an individual's gross income. 5 While the general contribution limit of $5,000 would be phased-in over several years, the limit for individuals 50 and over is increased immediately to $5,000 in 2001. 6 H.R. 2488 would have phased-in a permanent catch-up provision over five years, and the permitted catch-up amount would have been equal to 50 percent of the maximum annual IRA contribution limit. 3until it reaches $15,000 in 2005. The limit for 457s would be twice the otherwise applicable dollar limit in the three years prior to retirement. Finally, the Bill would increase the SIMPLE plan contribution limit in $1,000 increments beginning in 2001 until it reaches $10,000 in 2004; i.e., the SIMPLE plan contribution limit would be $7,000 in 2001 and $8,000 in 2002, etc. until it reaches $10,000 in 2004. The 402(g), 457 plan and SIMPLE plan limits would be indexed in $500 increments. These modifications would be effective for years beginning after December 31, 2000. Bill

Section 201; Description p. 5-7. B. Plan Loans Available to Subchapter S Shareholders, Partners and Sole Proprietors. The Bill would modify the prohibited transaction rules to permit plan loans to sole proprietors, partners, and Subchapter S corporation shareholders, effective after December 31, 2000. Bill Section 202; Description p. 7-8. C. Top-Heavy Rule Modification. The Bill would provide that a plan that satisfies the design-based safe harbor under section 401(k)(12) and the matching contribution requirements under section 401(m)(11) would not be deemed top-heavy. The Bill also would provide that matching or nonelective contributions provided 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. Finally, the family ownership attribution rule would no longer apply in determining whether an individual is a 5 percent owner of the employer. These modifications would be effective for years beginning after December 31, 2000. Bill Section 203; Description p. 8-12. D. Elective Deferrals Not Taken into Account for Deduction Limit. The Bill would provide that effective 2001, elective deferrals would no longer be considered employer contributions subject to Code section 404 deduction limits. Bill Section 204; Description p. 12-13. E. Modification of Definition of Compensation for Purposes of Deduction Limits. The Bill would modify Code section 404's definition of compensation to include elective deferral contributions, effective January 1, 2001. In addition, the Bill would increase the annual limitation on the amount of deductible contributions to a profit-sharing or stock bonus plan from 15 percent to 20 percent of compensation of the employees covered by the plan for the year.7 Bill Section 207; Description p. 15-16. F. Repeal of Coordination Requirements for 457 Plans. Effective January 1, 2001, 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. Bill Section 205; Description p. 13-14. G. Elimination of User Fees for Determination Letter Requests for Small Employers. Effective for letter requests made after December 31, 2000, 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) during the first 5 plan years of the plan. Bill Section 206; Description p. 14-15. 7 H.R. 2488 did not contain this latter provision that would raise the deductible contribution limits for profit-sharing and stock bonus plans. 4H. Optional Treatment of Elective Deferrals as After-Tax “Plus” Contributions to 401(k) Plans and 403(b) Annuities. The Bill would permit a 401(k) plan or 403(b) annuity to include a “qualified plus contribution program” under which an individual could elect to have all or a portion of his or her elective deferrals under the plan treated as after-tax contributions. Qualified distributions from the Plus program would be tax free, following rules described below. The proposal would be effective for taxable years beginning after December 31, 2000. Under the program, the annual contribution limit for Plus contributions would be the Code section 402(g) limit reduced by other elective deferrals. Plus contributions to 401(k) plans would be treated the same as other elective deferrals for purposes of the nondiscrimination requirements. A plan offering a Plus program would be required to maintain separate recordkeeping for Plus contributions and related earnings. Qualified distributions from the Plus program would not be includible in income. A qualified distribution would be one made after the five-taxable year period beginning with the first taxable year in which a participant made a Plus contribution and (i) made on or after the participant attains age 59 ½, (ii) made to a beneficiary or a participant’s estate upon the death of the participant, or (iii) made upon disability of the participant. Bill Section 208; Description p. 16-18. III. Enhancing Fairness for Women (Title III) A. Catch-Up Contributions for Individuals Age 50 or Over. The Bill would permit individuals who have attained age 50 before the end of the plan year to make additional elective contributions of up to $5,000 to 401(k), 403(b), SIMPLE and 457 plans. This amount would be indexed for inflation in $500 increments in 2006 and thereafter. The catch-up contributions, however, would be subject to nondiscrimination requirements. The provision would be effective for years beginning after December 31, 2000. Bill Section 301; Description p. 18-19 and Bill Amendment. (See also Bill Section 101, which permits similar catch-up contributions to IRAs). B. Equitable Treatment for Contributions of Employees to Defined Contribution Plans. Effective January 1, 2001, the section 415(c) limit on annual additions would be amended to increase the 25 percent of compensation limitation to 100 percent. The 33 1/3 percent of compensation limitation on deferrals under 457 plans would be changed to 100 percent. The exclusion allowance applicable to contributions to section 403(b) annuities would be repealed. The Bill also would direct Treasury to revise the regulations relating to the exclusion allowance under section 403(b)(2) to render void the requirement that contributions to a defined benefit plan be treated as previously excluded amounts for purposes of the exclusion allowance. Bill Section 302; Description p. 20-22. C. Faster Vesting of Certain Employer Matching Contributions. The Bill would require employer matching contributions (as defined in Code section 401(m)(4)(A)) to be vested on a 3-year cliff or 6-year graded vesting schedule, generally effective for contributions made for plan years beginning after December 31, 2000.8 Bill Section 303; Description p. 22-23. D. Simplification and Modification of the Minimum Required Distribution Rules. The Bill would modify the current minimum required distribution (“MRD”) rules, effective after December 31, 2000. First, the proposal would apply the MRD rules currently applicable to distributions where the 8 Unlike H.R. 2488, the Bill does not include a parallel amendment to ERISA. 5participant 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 the date of death or begin within one year of the date of death and be paid over the life or life expectancy of a designated beneficiary. The Bill, however, would permit surviving spouses to begin distributions when the spouse turns 70 1/2. The proposal 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. Second, the Bill would reduce the excise tax on failures to satisfy the MRD rules from 50 percent to 10 percent. Third, 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 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 409 of the Bill would apply the MRD rules to 457 plans, thereby repealing the special MRD rules currently applicable to 457 plans. Bill Sections 304 and 409; Description p. 23-25. E. Clarification of Division of 457 Plan Assets in Divorce. The Bill would apply the tax rules for qualified plan distributions pursuant to a qualified domestic relations order (“QDRO”) (Code 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. This provision would apply to transfers, distributions, and payments made after December 31, 2000. Bill Section 305; Description p. 25-26. F. Modification of 401(k) Hardship Withdrawal Safe Harbor. The Bill would direct the Secretary of the Treasury to revise regulations addressing 401(k) hardship distributions to reduce from 12 to 6 months the period during which an employee must be prohibited from making contributions after taking a distribution on account of hardship. The revised regulations would apply to years beginning after December 31, 2000. Bill Section 306; Description p. 26-27. IV. Increasing Portability for Participants (Title IV) A. Rollovers of Retirement Plan and IRA Distributions. Effective January 1, 2001, eligible rollover distributions from qualified retirement plans, section 403(b) annuities and governmental section 457 plans generally could be rolled over to any of such plans or arrangements. Similarly, taxable amounts in a traditional IRA (i.e., all but account basis) could be rolled over into a qualified plan, section 403(b) annuity or governmental section 457 plan. Direct rollover and withholding rules would be extended to section 457 plans. No plan, however, would be required to accept rollovers. Distributions from a qualified plan would not be eligible for capital gains or income averaging treatment if there was a rollover to the plan that would not have been permitted under current law. Amounts distributed from a section 457 plan would be subject to the early withdrawal tax to the extent the distribution consists of amounts attributable to rollovers from another type of plan; section 457 plans accepting such rollovers would be required to separately account for such amounts. The section 402(f) rollover notice, which would be required of all plans, would be required to describe the extent to which distribution rules and tax consequences may differ from plan to plan. Bill Sections 401 and 402; Description p. 27-31. B. Rollover of After-Tax Contributions. The Bill would permit the rollover of after-tax contributions from a qualified plan to another qualified plan or a traditional IRA for distributions made after December 31, 2000. Plan-to-plan rollovers of after-tax monies would be required to be direct 6rollovers. Plans accepting such rollovers would be required to separately account for them. After-tax contributions rolled over to an IRA, however, would be tracked by the taxpayer (see subparagraph C, below). After-tax contributions in an IRA (including those rolled from a qualified plan and nondeductible contributions to an IRA) would not be permitted to be rolled over from the IRA to a qualified plan, 403(b) annuity or 457 plan. In the case of a distribution from an IRA that is rolled over into those plan types, the distribution is attributed first to taxable amounts (i.e., all amounts other than after-tax contributions). Bill Section 403; Description p. 30-31. C. Issuance of Regulatory Guidance on Rollovers. The accompanying Description (prepared by the Joint Tax Committee) provides that the IRS would be directed to issue rules with respect to reporting and mechanisms to address mistakes relating to rollovers and to develop forms (for example, by expanding the Form 8606) to assist individuals in tracking after-tax contributions rolled over to an IRA. Description p. 31. D. Hardship Exception to 60-Day Rollover Rule. The Bill would authorize Treasury to waive the 60-day rollover requirement if the failure to waive such requirement would be against “equity or good conscience,” including cases of casualty, disaster or other events beyond the reasonable control of the individual. The provision would apply to distributions after December 31, 2000. Bill Section 404; Description p. 31. E. Anticutback Rule Relief with Respect to Forms of Distribution. The Bill would permit the transfer of a participant’s accrued benefit from one defined contribution plan to another even though the transferee plan does not provide all of the forms of distribution available under the transferor plan. Such transfers would be permitted if (i) the transfer is either the result of a merger or consolidation of plans or is in the form of a direct transfer, (ii) the terms of each plan permit the transfer and the transferee plan permits distributions in the form of a single lump sum distribution, and (iii) the transfer is by voluntary election of the plan participant and, to the extent required by Code section 417, the participant’s spouse consents to the transfer. The Bill also provides that a defined contribution plan would not be treated as violating the anticutback rule (Code section 411(d)(6)) if the plan is amended to eliminate a form of distribution previously available as long as a lump sum distribution is available (for those benefit accruals that would have been protected under section 411(d)(6)) when the form of distribution is eliminated. The effective date of the proposal would be January 1, 2001. Furthermore, Treasury would be directed to issue regulations allowing the elimination of optional forms of benefit provided the rights of participants are not adversely affected in a material manner. Such regulations would be required to be issued by December 31, 2001. Bill Section 405; Description p. 32- 33.9 F. Repeal of Same Desk Rule. Effective for distributions after December 31, 2000, the Bill would modify the distribution restrictions applicable to 401(k) plans, 403(b) arrangements and 457 plans to permit distribution upon "severance from employment," rather than from "separation from service." Bill Section 406; Description p. 34. 9 Unlike H.R. 2488, the Bill does not include a parallel amendment to ERISA. 7G. Purchase of Service Credit in Governmental Defined Benefit Plans. The Bill would permit state and local government employees to transfer assets (in a trustee-to-trustee transfer) from their 403(b) arrangement or 457 plan to purchase service credits under their defined benefit plan, effective for trustee to trustee transfers after December 31, 2000. Bill Section 407; Description p. 35.10 H. Disregard of Rollovers When Applying Cash-Out Rules. Effective January 1, 2001, the Bill would permit plans to disregard amounts that had been rolled over into the plan when determining the present value of an individual participant's accrued benefit for purposes of making involuntary distributions from the plan. (Under current law, involuntary distributions are permitted if the accrued benefit does not exceed $5,000.) Bill Section 408; Description p. 35-36.11 V. Strengthening Pension Security and Enforcement (Title V) A. Miscellaneous Defined Benefit Plan Provisions. Titles V and VI of the Bill contain various provisions relating to defined benefit plans. These include provisions that would direct Treasury to prepare a report on the effects of conversions of traditional defined benefit plans to cash balance or hybrid formula plans (Bill Section 504; Bill Amendment); repeal the 150 percent of current liability funding limit over a phase-in period (Bill Section 501; Description p. 36-38); provide relief from excise tax for sound pension funding (Bill Section 503; Description p. 38-39); impose an excise tax for failure to provide notice regarding significant reductions of future benefit accruals (Bill Section 504; Description p. 39-41); exempt multiemployer plans from the 100 percent of compensation limitation in Code section 415(b)(1) and modify other rules governing multiemployer plans (Bill Section 505; Description p. 41-42); and modify plan valuation timing requirements (Bill Section 601; Description p. 45). B. Miscellaneous ESOP Provisions: Titles V and VI of the Bill contain provisions relating to prohibitions of allocations of stock in S Corporation ESOPs, and ESOP dividend reinvestments. Bill Sections 506, 602; Description p. 42-45, 46. VI. Reducing Regulatory Burdens (Title VI) A. Employees of Tax-Exempt Organizations and 401(k) Plan Formation. The Bill would rectify problems created by an IRS rule implemented before Congress permitted tax-exempt entities to form 401(k) plans. Specifically, Congress permitted tax-exempt entities to establish 401(k) plans through the Small Business Job Protection Act of 1996. Previously implemented IRS rules provide that employees of tax-exempt entities could be excluded from the 401(k) coverage rules, if an affiliated entity established a 401(k) plan, because employees of the tax-exempt entity could not participate in the plan. The Bill directs Treasury to modify its rule to accommodate the SBJPA change as follows: employees who are eligible to make elective deferrals under 403(b) arrangements may be treated as excludable for purposes of the 401(k) plan if no employee of that relevant organization is eligible to participate in the 401(k) plan and 95 percent of the employees who are not employees of that organization are eligible to participate in the 401(k) plan. Bill Section 604; Description p. 47-48. B. Clarification of Treatment of Employer-Provided Retirement Advice. Effective for years beginning after December 31, 2000, the Bill would provide that qualified retirement planing services 10 The Bill's proposed statutory language varies slightly from that in H.R. 2488. The difference, however, appears to have little substantive effect. 11 Unlike H.R. 2488, the Bill does not include a parallel amendment to ERISA. 8provided to an employee and his or her spouse are excludable from income and wages as an excludable fringe benefit. Such services, however, must be made available on a substantially equal basis to employees normally provided education and information regarding the employer's retirement plan. Bill Section 605; Description p. 48-49. C. Simplified Annual Filing Requirement for Owners and Their Spouses. The Bill would direct Treasury to eliminate the annual filing requirements for one-participant retirement plans with $250,000 in assets or less. Similarly, retirement plans that cover less than 25 employees would need to file only a simplified form substantially similar to that presently required of one-participant plans. The provision would be effective January 1, 2001. Bill Section 606; Description p. 49-50. D. Improvement of Employee Plans Compliance Resolution System (EPCRS). The Bill would direct the Secretary to update and improve EPCRS by (i) increasing the awareness and knowledge of small employers concerning the availability and use of the program; (ii) taking into account special concerns and circumstances that small employers face with respect to compliance and correction of compliance failures; (iii) extending the duration of the self-correction period under the Administrative Policy Regarding Self-Correction for significant compliance failures; (iv) expanding the availability to correct insignificant compliance failures under the Administrative Policy Regarding Self-Correction during audit; and (v) 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. Bill Section 607; Description p. 50-51. E. Repeal of the Multiple Use Test. The Bill would repeal the multiple use test under Code section 401(m) for years beginning after December 31, 2000. Bill Section 608; Description p. 51-53. F. Flexibility in Nondiscrimination, Coverage, and Line of Business Rules. The Bill would direct Treasury to modify its regulations to permit plans to satisfy the section 401(a)(4) nondiscrimination and section 410(b) coverage requirements using "facts and circumstances" tests in cases where the current mechanical tests are not satisfied. Under the regulations, a plan would be submitted to the IRS for a determination whether the test has been met. The regulations would apply in years beginning after December 31, 2000. Similarly, the Bill would direct Treasury to modify existing line of business regulations to allow plans to meet a facts and circumstances test. Bill Section 609; Description p. 53-54. G. Extension to All Governmental Plans of Moratorium of Certain Nondiscrimination Rules Applicable to State and Local Government Plans. The Bill would exempt all governmental plans (as defined in Code section 414(d)) from the nondiscrimination and minimum participation rules. Currently, governmental plans that are not qualified plans maintained by a state or local government are not exempt from these rules. The provision would be effective for plan years beginning after December 31, 2000.12 Bill Section 610; Description p. 54. VII. Plan Amendments (Title VII) 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. Bill Section 701; Description p. 56. 12 H.R. 2488 would have extended the exemption only to governmental plans maintained by tax-exempt "international organizations." 9Thomas T. Kim Assistant Counsel Attachment