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Congressional Research Service

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Pension Reform: The Pension Preservation and Savings Expansion Act of 2003

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Summary

H.R. 1776 (Portman/Cardin), the *Pension Preservation and Savings Expansion Act* was introduced April 11, 2003. Provisions of the bill would make permanent the pension provisions of the *Economic Growth and Tax Relief Reconciliation Act of 2001* (EGTRRA), which otherwise expire after 2010, and accelerate the scheduled increases in contribution limits to individual retirement accounts and employer-sponsored plans that were included in the EGTRRA of 2001. The bill also would expand and make permanent a non-refundable tax credit for low- and moderate-income individuals who contribute to a qualified retirement plan. It would replace the interest rate on 30-year Treasury bonds as the rate used by defined benefit plans to calculate funding ratios and lump-sum distribution amounts. It would allow retirees to use distributions from a retirement plan to pay premiums for employer-based health insurance on a pre-tax basis, and allow up to \$2,000 of retirement annuity income to be free of income taxes. It would raise from 70½ to 75 the age at which participants must begin to take distributions from pension plans and individual retirement accounts and reduce the excise tax for not taking required distributions. It would allow workers to diversify company stock acquired through employer matching contributions after 3 years of service and company stock acquired through other employer contributions after 5 years of service. The bill would allow disabled persons to contribute unearned income to retirement plans and to qualify for Supplemental Security Income (SSI) while holding retirement assets of \$75,000 or more.

This report will be updated periodically. For a section-by-section summary of the bill see CRS Report RL31939, "Pensions and Retirement Savings Plans: Comparison of H.R. 1776 with Current Law."

Making Today's Savings Opportunities Permanent. The *Economic Growth and Tax Relief Reconciliation Act of 2001* ("EGTRRA," P.L. 107-16) provides that the the Act shall not apply after December 31, 2010. H.R. 1776 would make permanent the provisions of P.L. 107-16 relating to pensions and individual retirement arrangements.

Preserving Retirement Assets. The Internal Revenue Code (I.R.C.) requires plan participants and owners of traditional IRAs to begin taking distributions no later than April of the year after reaching age 70½. An exception allows participants in employer-sponsored plans who are still working at age 70½ to delay distributions until April of the year after they have retired, unless they own 5% or more of the firm. If a participant in a defined benefit plan retires after age 70½, the benefit must be increased in an actuarially fair manner. Failure to take a required distribution results in a tax penalty equal to 50% of the amount that should have been distributed. Under H.R. 1776, the required beginning date for distributions would be increased from 70½ to 75 (see chart, below). The excise tax for failure to take a required minimum distribution would be reduced from 50% to 20% of the amount that should have been distributed.

Year	Required beginning date
2004-2005	December 31 of year person reaches age 72
2006-2007	December 31 of year person reaches age 73
2008-2009	December 31 of year person reaches age 74
2010 and later	December 31 of year person reaches age 75

As under current law, distributions could be delayed until retirement (if later) except for traditional IRAs and 5% owners of a firm. Actuarial adjustment would continue to be required for defined benefit plan participants who retire after age 70½.

Enhancing Fairness and Pension Portability. Under current law, a transfer of IRA assets from the IRA owner to his or her spouse's IRA is taxable except in cases of divorce or death of the account owner. H.R. 1776 would provide that a transfer of IRA assets between spouses' IRAs would in most cases not be treated as a taxable distribution.

The I.R.C. requires employees to be fully vested in nonelective employer contributions (i.e., contributions other than matching contributions) after no more than 5 years of service, or in increments of 20% beginning in the third year with full vesting after 7 years. Employees must be fully vested in employer matching contributions after no more than 3 years of service, or in increments of 20% beginning in the second year with full vesting after 6 years. Under H.R. 1776, vesting in nonelective employer contributions would be the same as vesting in employer matching contributions. Employees would be fully vested in nonelective employer contributions after no more than 3 years of service, or in increments of 20% beginning in the second year with full vesting after 6 years.

Most distributions from retirement plans are taxed as ordinary income, whether they are received as a lump-sum distribution or in the form of an annuity. (Any distribution that represents repayment to the participant of amounts that he or she contributed to the plan with after-tax dollars is excluded from taxable income.) H.R. 1776 would allow a percentage of annuity payments from an employer-sponsored plan or an IRA to be excluded from taxable income. For tax years 2004 to 2007, 5% of annuity payments up to \$20,000 could be excluded from income to a maximum exclusion of \$1,000 per year. In 2008 and later, 10% of annuity payments could be excluded. The \$20,000 limit on countable annuity payments would be indexed to inflation. The exclusion would be phased out for single tax filers with adjusted gross income between \$75,000 and \$90,000 and for joint filers with AGI from \$150,000 to \$180,000.

I.R.C. §72(t), imposes a 10% penalty on distributions from an employer-sponsored plan or IRA that occur before age 59½. There are several exceptions to the 10% penalty, including distributions made as a series of substantially equal periodic payments that are based on the life expectancy of the plan participant or the joint life expectancies of the participant and his or her designated beneficiary. If the series of payments is terminated or modified (except because of death or disability) before the *later of* age 59½ or the end of a 5-year period beginning on the date of the first distribution, the entire series of distributions is subject to the 10% penalty. IRS Revenue Ruling 2002-62 allows an individual to elect a one-time change in the series of equal periodic payments without incurring the tax penalty. The ruling specifies that either a nontaxable transfer of a portion of the account balance to another retirement plan or a rollover of the amount received by the taxpayer to another account will be treated as a modification of the series of payments, resulting in all distributions being subject to the 10% tax penalty. The interest rate used in calculating these payments may not exceed 120% of the federal mid-term rate.

H.R. 1776 would amend I.R.C. §72(t) such that a change from one permissible method of calculating substantially equal periodic payments to another permissible method would not be subject to the 10% tax penalty if the change results initially in a reduction in the amount of the payments. It would further provide that if amounts are being received as a series of substantially equal periodic payments, and a transfer or rollover is made into another tax-qualified retirement plan, the 10% tax penalty will not be applied. It also would provide that any “reasonable” interest rate may be used in determining whether distributions are substantially equal periodic payments.

The Supplemental Security Income (SSI) program is a means-tested, federally administered income assistance program that provides monthly cash payments to needy aged, blind, and disabled persons. The maximum SSI payment in 2003 is \$552 per month for a single person and \$829 for a couple. The asset limit for SSI eligibility is \$2,000 for a single person and \$3,000 for a couple. Under H.R. 1776, \$75,000 or more in a qualified retirement account would be excluded from assets in determining eligibility for SSI. Beginning at age 60½, the Social Security Administration would count as monthly income the annuity value of a retirement account balance and offset SSI benefits by that amount, regardless of whether or not the individual has converted the account to an annuity.

Increasing Retirement Plan Participation and Savings. The EGTRRA of 2001 authorized a non-refundable tax credit equal to a percentage of the first \$2,000 contributed annually to a qualified retirement plan by low- and moderate-income individuals and families. The credit does not apply to years that begin after December 31, 2006. Under H.R. 1776, the non-refundable credit would be made permanent and would be expanded for tax years after 2003 according to the following schedule:

Single return	Joint return	Credit
AGI < \$15,000	AGI < \$30,000	55%
15,001 to 20,000	30,001 to 40,000	25%
20,001 to 25,000	40,001 to 50,000	20%
25,001 to 30,000	50,001 to 60,000	10%

The EGTRRA of 2001 increased the maximum annual employee contribution to qualified retirement plans authorized under sections 401(k), 403(b), and 457(b) on a phased-in schedule, with the maximum reaching \$15,000 in 2006. H.R. 1776 would raise the maximum annual employee contribution to a qualified retirement plan to \$15,000 in 2004 and index this amount to inflation in \$500 increments in later years. EGTRRA also increased the maximum annual employee contribution to a Savings Incentive Match Plan (SIMPLE) retirement plan, with the maximum reaching \$10,000 in 2005. H.R. 1776 would raise the maximum annual employee contribution to a SIMPLE retirement plan to \$10,000 in 2004, indexed to inflation in \$500 increments in later years.

The EGTRRA amended I.R.C. §414(v) to permit persons age 50 and older to make additional contributions to retirement plans, according to the following schedule:

Year	401(k), 403(b), 457(b)	SIMPLE
2003	\$2,000	\$1,000
2004	3,000	1,500
2005	4,000	2,000
2006	5,000	2,500

Under H.R. 1776, the maximum additional contribution to plans under sections 401(k), 403(b), and 457(b) by individuals age 50 and older would be increased to \$5,000 in 2004 and indexed to inflation in \$500 increments in later years. The maximum additional contribution to a SIMPLE plan by individuals age 50 and older would be increased to \$2,500 in 2004 and indexed to inflation in \$500 increments in later years.

IRS rules allow firms to enroll employees automatically in salary reduction retirement savings plans, provided that employees receive notice of the arrangement and have the opportunity to choose not to participate. ERISA §404(c) provides that if an employee can exercise control over the investment of the funds in a qualified retirement plan, the employer will not be held liable for investment losses that the employee experiences as a result of exercising that control. H.R. 1776 would amend ERISA §404(c) to authorize “automatic contribution trust arrangements” under which the employer could contribute a uniform percentage of employee pay to a retirement account that is invested in accordance with regulations to be prescribed by the Secretary of Labor. Employees must be notified of their right not to participate in the plan and also of the assets in which the contributions to the plan will be invested in the absence of specific directions by the employee. It would amend I.R.C. §514(b) to supersede any state laws that otherwise would prohibit automatic enrollment in a qualified retirement savings plan.

Expanding Retirement Plan Coverage to Employees of Small Businesses. As authorized by P.L. 104-188, an employer with 100 or fewer employees can establish a SIMPLE plan. Under a SIMPLE plan, an employer must either (1) match 100% of employee salary deferrals up to 3% of pay (to a maximum match of \$6,000 in 2003) for all *participating* employees or (2) make a nonelective employer contribution of 2% of pay (up to \$4,000 in 2003) for all *eligible* employees. No other contributions are permitted. Under H.R. 1776, an employer could choose to make an additional nonelective contribution of a uniform percentage of pay up to 10% of total compensation for each eligible employee, regardless of whether the employer also is making a matching contribution. An employer that sponsors a SIMPLE 401(k) could make matching

contributions of less than 3% of pay, provided that the contribution is at least 1% of pay and the reduced contribution is not in effect for more than 2 years in a 5-year period ending in the current year. A small employer that has not sponsored a retirement plan in the previous 2 years, and that is otherwise eligible to sponsor a SIMPLE plan, could adopt a SIMPLE plan funded entirely through employees' elective deferrals with no employer contributions. Employees could defer up to \$5,000 per year, indexed to inflation. The Secretary of the Treasury would be required to propose regulations that would permit an employer to replace a SIMPLE plan with another tax-qualified plan in mid-year. The bill would lower the tax penalty on distributions from a SIMPLE IRA during the first 2 years of participation to 10% of the amount distributed, and it would allow individuals to roll over balances from any other type of qualified retirement savings plan into a SIMPLE IRA. Amounts held in a SIMPLE IRA could be rolled over into other qualified retirement plans to the same extent as other IRAs.

Strengthening Individual Retirement Arrangements. The EGTRRA of 2001 increased the maximum annual contribution to an IRA. The maximum reaches \$5,000 in 2008. H.R. 1776 would increase the maximum annual contribution to an IRA to \$5,000 in 2004 and index it to inflation in \$500 increments in later years. EGTRRA allows individuals age 50 and older to make additional contributions of up to \$500 to IRAs through 2005, and \$1,000 in 2006 and later years. Under H.R. 1776, the maximum additional contribution to an IRA by persons age 50 and older would be increased to \$1,000 in 2004 and later years. IRA contributions are limited to the lesser of a specific dollar amount (currently \$3,000) or the individual's *earned income* for the year. Under H.R. 1776, disabled persons, as defined in I.R.C. §72(m)(7), could contribute to an IRA, regardless of whether they had earned income for the year of the contribution, provided that they had not yet reached age 70½.

Revitalizing Defined Benefit Plans. Most defined benefit plans in the private sector are funded entirely by the employer. Any required employee contributions must be made on an after-tax basis. In the public sector, most governmental defined benefit plans require the employee to contribute to the plan, but governmental employers can choose to take employee contributions on a pre-tax basis. Under H.R. 1776, private-sector employers could treat employee contributions to defined benefit plans as pre-tax dollars.

Under current law, the interest rate on 30-year U.S. Treasury Bonds must be used to determine the funded status of a defined benefit plan, to calculate the amount of lump-sum distributions to plan participants, and to determine maximum benefit amounts. The Treasury Department no longer issues 30-year bonds. H.R. 1776 would replace the interest rate on 30-year Treasury Bonds as the rate for determining the funded status of defined benefit plans with an interest rate based on an index of high-quality, long-term corporate bonds. For calculating lump-sum distributions, the corporate bond rate would be phased in over 4 years beginning in 2006. For determining maximum benefit amounts, the Treasury interest rate would be replaced by a rate of 5.5% beginning in 2004.

Restricting Excessive Remuneration. The tax code imposes an excise tax of 20% on certain payments to owners and officers of a corporation that are contingent on a change in company ownership or control of assets. H.R. 1776 would impose an excise tax of 50% on "excessive employee remuneration" (including nonqualified pension benefits) that is paid during bankruptcy and the 2 years preceding a bankruptcy filing. In

the case of company payments made to cover an employee's income taxes on such remuneration, the excise tax would be 100%.

Defined Contribution Plan Protections. H.R. 1776 would require all defined contribution plans to provide quarterly "investment education notices" that would include an explanation of generally accepted investment principles, including principles of risk management and diversification, and a discussion of the risk of holding substantial portions of a portfolio in the security of any one entity, such as employer securities. The Sarbanes-Oxley Act of 2002 (P.L. 107-204) allows the Secretary of Labor to assess a civil penalty of up to \$100 per participant per day on a plan that fails to notify participants 30 days in advance of any period of 3 or more days during which 50% or more of a plan's participants would be unable to trade the employer's securities. H.R. 1776 would levy an excise tax of \$100 per participant on any non-ERISA plan that fails to provide notice 30 days in advance of any period of 3 or more days during which 50% or more of a plan's participants would be unable to trade the employer's securities.

Employers sometimes make contributions to defined contribution plans with shares of the employer's stock. They sometimes require employees to hold this stock until separation or until age 50 or 55. Under H.R. 1776, employers could not require employees to purchase company stock with their own salary deferrals. Employees could sell company stock acquired through employer matching contributions after 3 years of service and company stock acquired through other employer contributions after 5 years of service. The diversification requirement would be phased in from 2004 to 2008. It would not apply to (1) employee stock ownership plans (ESOPs) that hold neither employer salary deferrals nor employer matching contributions or (2) plans that do not hold company stock that is readily traded on a public stock exchange.

Other Elements of Retirement Security. Retired employees who purchase health insurance through a former employer pay the premiums with after-tax income. H.R. 1776 would allow retirees to pay for health insurance purchased through a former employer with pre-tax income, provided that the premium is paid in whole or in part with distributions from an employer-sponsored plan. Prior to 2010, the limit on plan distributions used for pre-tax payment of health insurance premiums would be \$500 in 2004 and 2005, \$1,000 in 2006 and 2007, and \$2,000 in 2008 and 2009.

Financial accounting standards require public corporations to report on their financial statements any unfunded obligation for retiree health insurance benefits. Employers are not required to pre-fund these obligations. Under I.R.C. §401(h), an account maintained as part of a defined benefit plan or money purchase plan can be used to pre-fund some retiree health benefits. H.R. 1776 would amend I.R.C. §401(h) so that accounts to pre-fund retiree health benefits also could be maintained under profit-sharing or stock bonus plans. Employer contributions to the 401(h) account would be limited to 25% of the employer's total contributions to the plan, as under current law, except that for profit-sharing and stock bonus plans the limit would be 5% in 2004 and 2005, 10% in 2006 and 2007, and 20% in 2008 and 2009.