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Pension Preservation and Savings Expansion Act of 2003 (H.R. 1776), as Approved by the House Committee on Ways and Means July 18, 2003

Brief Summary of Principal Provisions*

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* All provisions generally effective after 2003 except as indicated.

A. Incorporation of Pending/Prior Legislation

Acceleration of EGTRRA Contribution Limit Increases. Accelerates, by two years, the contribution and catch-up limit increases being phased in under EGTRRA. Beginning in 2004, the elective deferral and 457(b) contribution limit increases to $15,000 ($10,000 for SIMPLEs), and the catch-up limit increases to $5,000 ($2,500 for SIMPLEs). Thereafter, the limits are indexed as under current law.

Saver's Credit. EGTRRA created a temporary nonrefundable tax credit applicable to certain low- and moderate-income individuals who make elective contributions to certain employer-sponsored plans, IRAs or Roth IRAs. The credit is currently scheduled to expire after 2006. The bill extends the credit through 2010 and modestly expands the AGI limits on eligibility for the credit.

EGTRRA "Leftovers". Incorporates ten or so tax code and ERISA changes from previous Portman-Cardin legislation that were left out of EGTRRA for procedural reasons.

ISO/ESPP Employment Tax Relief. Permanently excludes from FICA and FUTA amounts realized on the exercise of incentive stock options (ISOs) and employee stock purchase plans (ESPPs).

B. Plan Contributions

Mandatory Employee Contributions to Non-Governmental Defined Benefit Plans. Provides that "qualified mandatory employee contributions" to certain non-governmental defined benefit plans are not includible in income in the year of contribution. "Qualified mandatory employee contributions" are defined as mandatory contributions (as defined under the vesting rules) that do not exceed two percent of compensation (as defined under sec. 415(c)(3)) made pursuant to a non-governmental defined benefit plan in effect on January 1, 2003, determined without regard to any amendments made after that date. The defined benefit plan must also (1) require employee contributions as a condition of participation, (2) allow an employee to make a one-time irrevocable election to participate in the plan, and (3) not maintain the contributions in a separate sec. 414(k) account. This provision replaces a provision in the introduced bill that would have permitted pick-up contributions under a defined benefit plan (401(a) or 403(a)) maintained by a private employer.

Deduction Rules for Combined DB/DC Plans. Code sec. 404(a)(7) provides a special deduction limitation applicable to employers who sponsor a combination of defined contribution and defined benefit plans. The bill amends this rule so the special limitation applies only to employer contributions in excess of 6 percent of covered employee compensation.

C. Defined Benefit Funding

Replacement of 30-Year Treasury Rate. For plans years beginning after December 31, 2003, and before January 1, 2007, temporarily replaces the interest rate on 30-Year Treasury securities with the rate of interest on "amounts conservatively invested in long-term corporate bonds" for pension funding and PBGC premium purposes. For purposes of determining lump sum distributions, begins phasing in a similar change which only applies for plan years beginning in 2006. Directs Treasury to prescribe by regulation a method for determining this rate based on one or more indices as determined by the Secretary. Existing averaging mechanisms and corridors continue to apply. For purposes of applying the Code sec. 415 benefit limitations to non-annuity forms of payment, the 30-Year rate is replaced with a rate of 5.5 percent for years beginning in 2004, 2005, and 2006.

D. Plan Distributions

Easing Minimum Distribution Rules. Gradually increases the minimum distribution "required beginning date" from age 70-1/2 to age 72 in 2004 through 2007 and to age 75 in 2008 and thereafter. (The actuarial adjustment of delayed benefits under defined benefit plans would continue to be based upon April 1 of the year after the individual turns 70-1/2.) Reduces the excise tax for failure to pay out the minimum distributions from 50 percent to 20 percent of the shortfall.

Partial Exclusion of Lifetime Annuity Payments. Provides for a partial exclusion of the first 5 years of "lifetime annuity payments" received by an employee, spouse, or alternate payee from a qualified defined contribution plan, 403(b), governmental 457(b) plan, or IRA. "Lifetime annuity payment" is defined generally as a distribution which is part of a series of substantially equal periodic payments (made not less frequently than annually) over the life of the distributee or the joint lives of the distributee and designated beneficiary. The maximum exclusion amount for any year is equal to 10 percent of lifetime annuity payments, up to a cap of 1/2 of the sec. 415(c) defined contribution dollar limit. Thus, if the sec. 415(c) dollar limit remains $40,000 in 2004, the maximum annual exclusion would be $2,000 (10% of $20,000). The exclusion is phased out for single participants between $60,000-$75,000 and for married participants filing jointly between $120,000-$150,000 (indexed).

Relaxation of Early Withdrawal Tax for Periodic Payments. Expands upon the relief provided under Revenue Ruling 2002-62 for modifications of substantially equal periodic payments under the exception to the 10 percent additional tax on early distributions. The bill (unlike the IRS ruling) would allow any reasonable interest rate to calculate payments. Also permits the substantially equal payment requirement to be satisfied when a portion of the participant's benefit is transferred or rolled to another plan, if, in the aggregate, the requirement is still satisfied (e.g., if the payments continue under the transferee plan).

Distribution of an Annuity Contract. Effective January 1, 2000, reinstates the rule that a distribution of an annuity contract can be part of a lump sum distribution for net unrealized appreciation (NUA) purposes.

E. Plan Qualification

Faster Vesting for All DC Plan Contributions. Generally requires use of the 3-year cliff or 2-6 year graded vesting schedules, which currently only apply to matching contributions, for post-2003 employer contributions to defined contribution plans. The 5-year cliff and 3-7 year graded vesting schedules would still apply to defined benefit plans.

Correction of ADP and ACP Excesses. For purposes of the 10 percent excise tax that applies to employers with respect to excess contributions under the ADP or ACP tests, expands the correction period for distributions of excess contributions (plus earnings) from 2½ months to 6 months following the close of the plan year. Also provides that distributions of excess contributions (plus earnings) no later than 6 months following the close of the plan year may be taxed in the year distributed (rather than the year of contribution), regardless of the amount distributed.

Catch-up Nondiscrimination Rule. The new catch-up contribution rules enacted as part of EGTRRA require generally that all eligible participants be permitted to elect catch-up contributions (the "universal availability" test). The bill provides that, in applying the universal availability test, (1) employees covered under a collective bargaining agreement and nonresident aliens who receive no earned income from the employer from sources within the U.S. are not taken into account, (2) the test may be applied separately to separate lines of business, and (3) a plan does not fail to satisfy the test solely because another plan maintained by the employer that is qualified under Puerto Rico law does not provide for catch-up contributions. The recently issued final Treasury regulations provide that employees covered under a collective bargaining agreement and nonresident aliens who receive no earned income from the employer from sources within the U.S. do not have to be taken into account, but provide no relief for separate lines of business. An IRS notice (affirmed by the preamble to the final catch-up regulations) provides relief, until further guidance is issued, with respect to plans qualified under Puerto Rico law.

Transfers to the PBGC/ Missing Participants. Under the default rollover rules enacted by EGTRRA, involuntary cash-outs that exceed $1,000 will have to be rolled over to an IRA in certain cases after the issuance of final DOL regulations. Effective as if included in EGTRRA, the bill permits the plan administrator to transfer the involuntary cash-out to the PBGC instead of to an IRA, unless the participant elects otherwise. The transfer to the PBGC is treated as a transfer to an IRA (i.e., is tax-free), and amounts distributed by the PBGC generally are treated as a distribution from an IRA. Upon an application filed by the participant or beneficiary, amounts may be distributed by the

PBGC in a single sum (plus interest) or in another form specified in PBGC regulations. The bill also directs PBGC to prescribe rules for terminating multiemployer plans similar to the current law missing participant rules applicable to single employer plans subject to ERISA Title IV. The missing participant program is also made available to plan administrators of certain types of plans not subject to PBGC, including defined contribution plans.

Voluntary Compliance. In an effort to improve on the IRS qualified plan correction programs, the bill (effective with enactment) protects a plan from disqualification if it makes good faith efforts to comply, but inadvertently fails to satisfy 1 or more requirements, and either substantially corrects the failures before the date the plan becomes subject to IRS examination or on or after such date. If corrections are made after the plan becomes subject to examination, the Secretary may require payment from the sponsor in an amount not exceeding an amount that bears a reasonable relationship to the severity of the failure. The bill also makes similar changes to the 401(k) and 403(b) rules.

F. Portability

Rollovers for Nonspouse Beneficiaries. Extends the tax-free rollover provisions to non-spouse beneficiaries. A distribution from an eligible employer plan (401(a), 403(a), 403(b), or governmental 457 plan) may be rolled over in a direct trustee-to-trustee transfer to an inherited IRA of the nonspouse beneficiary. Thus, the nonspouse beneficiary may not make contributions to the inherited IRA or rollover distributions from the inherited IRA. To the extent provided in Treasury regulations, the provision also applies to a trust maintained for a designated beneficiary to the same extent it applies to the beneficiary. Distributions from the IRA must begin in the calendar year following the employee's death in the form of a life annuity or distribution must be completed within 5 years. This change essentially allows beneficiaries to do in an IRA what the new IRS minimum distribution rules allow them to do in an employer plan if the plan chooses to permit it.

Plan Rollovers to Roth IRAs. Permits distributions from eligible employer plans (i.e., 401(a), 403(a), 403(b), and governmental 457 plans) to be rolled over directly into Roth IRAs. (Current law requires rollover to a traditional IRA and then conversion to a Roth IRA.) The current limitations on conversions of traditional IRAs to Roth IRAs would continue to apply: (1) modified adjusted gross income cannot exceed $100,000, (2) the individual cannot be married and file a separate tax return, and (3) the rollover results in current taxable income to the extent it exceeds basis.

Rollover of After-Tax Amounts to 403(b) Plans. EGTRRA changed the rollover rules to permit rollovers of after-tax contributions to IRAs or a qualified plan in a direct rollover. The new bill clarifies that direct rollovers of after-tax contributions may be made to a 403(b) contract that agrees to separately account for such amounts (and earnings thereon).

G. Governmental Plans

Exception from 10% Early Distribution Excise Tax for Public Safety Employee "DROP" Plans. Distributions from certain police and fire department employee "DROP plans" are exempted from the 10 percent early distribution tax.

Clarifications to Permissive Service Credit Purchase Rules. Effective as if included in EGTRRA, clarifies that (1) "permissive service credit" includes credit for enhanced benefits associated with service that has already been credited under the plan; (2) transfers from 403(b) and 457(b) plans to governmental defined benefit plans are permissible if the transfer qualifies as a purchase of "permissive service credit" under Code section 415(n)(3), determined without regard to certain limitations (e.g., the 5-year participation requirement and the 5-year limit on "nonqualified" service); and (3) any amounts so transferred are distributed solely in accordance with the qualification requirements as applicable to the transferee defined benefit plan (even if the transferor plan was subject to more restrictive distribution rules).

Reasonable Good Faith Compliance with MRD Rules for Governmental Plans. Directs Treasury to issue regulations that provide that a governmental plan will be treated as having complied with Code section 401(a)(9) if it complies with a reasonable good faith interpretation of the statutory requirements.

H. Tax-Exempt Employers

403(b)/401(a) Plan Transfers and Mergers. Permits tax-free (1) transfers between qualified defined contribution (DC) plans and 403(b) plans of the same employer, and (2) mergers of qualified DC plans with 403(b) plans of the same employer, provided that there is no reduction in the vested benefit or total benefit of any participant or beneficiary, and provided that participant or beneficiary consent is obtained (if applicable under the terms of the plan, 403(b) contract or applicable law). Under current law, only rollovers are permitted between such plans. Distributions generally are made in accordance with the terms of the transferee or merged plan, but any grandfather treatment is retained (e.g., 10-year lump sum averaging, capital gain treatment). However, any transferred amounts (and earnings thereon) which were subject to the QJSA/QPSA (or the "profit-sharing" exception) requirements or the anti-cutback rule before the transfer or merger remain subject to those rules in the transferee plan. These rules are effective to transfers and mergers in years beginning after regulations are issued (which must be within 1 year of enactment).

Exceptions from 100% of Compensation Limit for Certain Church Plan Participants. Consistent with current law for governmental and multiemployer plans, the 100 percent of high 3-year-average compensation prong of the defined benefit plan limit under section 415(b) will not apply to a church plan, except in the case of "highly compensated benefits." "Highly compensated benefits" are benefits accrued on or after the first year in which the employee becomes a highly compensated employee under section 414(q). The exception will not apply if the church plan is a plan of a non-qualified church controlled organization (known as a "non-QCCO", typically a church-controlled hospital, college, university, or nursing home). This proposal addresses the problem of low-paid clergy whose annual benefit might exceed pre-retirement compensation.

In addition, amounts excludable as housing allowances under Code section 107 are not counted as compensation for 414(q) purposes. The bill also provides that, for purposes of applying the 100 percent of compensation limit to "highly compensated benefits, all benefits of the employee otherwise taken into account (without regard to this paragraph) shall be taken into account." This cryptic language appears to mean that, in the case of clergy who are highly compensated employees, "all benefits" under the plan, including any portion of the pension payments excludable as retired clergy housing allowance, will be subject to the 100 percent of compensation limit.

I. IRAs

Accelerated IRA Contributions. Accelerates the EGTRRA phase-in of the increase in the IRA contribution and catch-up limits. Beginning in 2004, the IRA limit will be $5,000 (indexed) and the catch-up limit will be $1,000 (indexed).

IRA Transfers to Spouses. Permits an individual to transfer his or her IRA to the individual's spouse tax-free at any time. Under current law, this is only permissible if the transfer is incident to divorce or upon the death of the IRA owner.

IRA Eligibility for the Disabled. Permits disabled taxpayers who have not yet reached the required beginning date for minimum distributions to make traditional and Roth IRA contributions, even if they have no compensation.

J. SEP/SIMPLE Plans

Additional Employer Contributions to Simple Plans. Adds a new nonelective employer contribution for SIMPLE IRAs and SIMPLE 401(k) plans. In addition to the employer match or 2 percent nonelective contribution, an employer may elect to make a nonelective employer contribution of a uniform percentage – up to 10 percent – of compensation for each eligible employee who earns at least $5,000 from the employer for the year.

Reduced Simple 401(k) Matching Contributions Permitted. Conforms the matching contribution rules for SIMPLE 401(k)s and SIMPLE IRAs. Thus, employers who sponsor SIMPLE 401(k)s may reduce the matching percentage to below 3 percent of compensation (but not less than 1 percent) for no more than 2 years in any 5-year period, i.e., the current rule for SIMPLE IRAs.

Conforming Definition of Compensation for SEP Limit. Changes the definition of compensation used for determining the 25 percent of compensation contribution limit to be consistent with the limit on contributions under defined contribution plans generally. Specifically, it replaces the taxable compensation definition under section 414(s) with a gross compensation definition under section 415(c)(3).

Level Dollar Contributions to SEPs. Permits SEP contributions to be made in a uniform dollar amount for each participant. Under current law, contributions are required to bear a uniform relationship to compensation in order to be nondiscriminatory.

Certain SEPs Exempt from Excise Tax on Nondeductible Contributions. EGTRRA added an exception to the 10 percent excise tax on nondeductible contributions for contributions to a SIMPLE plan not deductible solely because they are not made in connection with a trade or business of the employer. The bill expands the exception to apply to comparable SEP contributions.