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Pension Reform: The Economic Growth and Tax Relief Reconciliation Act of 2001

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Summary

On May 26, 2001, both the House of Representatives and the Senate agreed to the conference report on H.R. 1836, the *Economic Growth and Tax Relief Reconciliation Act of 2001*. Title VI of the bill deals with pension plans and retirement savings accounts. It contains many provisions similar to those that were included in H.R. 10, the *Comprehensive Retirement Security and Pension Reform Act of 2001* and in S. 742, the *Retirement Security and Savings Act of 2001*.

H.R. 1836 will increase the maximum annual contribution to an individual retirement account (IRA) from $2,000 per individual to $5,000. It also will increase the annual contribution limits on §401(k) plans, §403(b) annuities, and §457 deferred compensation plans for employees of state and local governments. Other measures are intended to encourage employers to offer pensions, increase participation by eligible employees, raise limits on benefits, improve asset portability, strengthen legal protections for plan participants, and reduce regulatory burdens on plan sponsors. The provisions of H.R. 1836 that reduce federal tax revenue are scheduled to sunset after 10 years. In June 2002, the House is expected to consider H.R. 4931 that would repeal the sunset.

Individual Retirement Accounts. The annual contribution limit for individual retirement accounts (IRAs) has not been changed since Congress established the current limit of $2,000 in 1981. H.R. 1836 will increase the annual limit on IRA contributions according to the following schedule:

Year	Maximum Contribution
2002	$3,000
2003	$3,000
2004	$3,000
2005	$4,000
2006	$4,000
2007	$4,000
2008	$5,000

In calendar years after 2008, the limit will be indexed to the Consumer Price Index in $500 increments. For individuals age 50 and older, the maximum allowable contribution to an IRA will increase by an additional $500 in 2002 through 2005 and by $1,000 in each year thereafter.

The bill will allow employers who maintain separate retirement savings accounts for their employees in addition to a tax-qualified retirement plan to designate those separate accounts as individual retirement accounts, provided that the accounts meet the requirements applicable to either traditional IRAs or Roth IRAs. These "deemed IRAs" will be subject to fewer reporting rules than tax-qualified employer-sponsored plans.

Benefit and Contribution Limits on Employer-sponsored Pensions and Retirement Savings Plans. Beginning in 2002, the maximum annual benefit payable by a tax-qualified defined benefit pension will increase from $140,000 to $160,000. Thereafter, it will be indexed to inflation in $5,000 increments. The annual limit on benefits will be reduced if benefits begin before age 62 and increased if benefits begin after age 65. A special rule will apply to airline pilots if they are required to retire before age 62. The limit on compensation that may be taken into account under a plan will increase from $170,000 in 2001 to $200,000 in 2002. It will be indexed in $5,000 increments. The limit on annual additions to defined contribution plans – comprising the sum of employer and employee contributions – will increase from $35,000 in 2001 to $40,000 in 2002, and it will be indexed in $1,000 increments.

In 2001, the limit on annual elective deferrals under Section 401(k) plans, Section 403(b) annuities, and salary-reduction **s**implified **e**mployee **p**ensions (SEPs) is $10,500, which is indexed to inflation in $500 increments. H.R. 1836 will increase this limit to $11,000 in 2002 and by $1,000 each year thereafter until it reaches $15,000 in 2006. In years after 2006, the annual limit on salary deferrals will be indexed to inflation in $500 increments. A Section 401(k) plan or a Section 403(b) annuity will be permitted to allow participants to elect to have all or a portion of their elective deferrals under the plan treated as after-tax contributions, called "designated Roth contributions." These contributions will be included in current income, but qualified distributions from designated Roth contributions will not be included in the participant's gross income. Such contributions will otherwise generally be treated the same as elective deferrals for purposes of the qualified plan rules.

The maximum deferral under a Section 457 plan for employees of state and local governments is $8,500 in 2001. H.R. 1836 will raise this limit to $11,000 in 2002,

$12,000 in 2003, $13,000 in 2004, $14,000 in 2005, and $15,000 in 2006. The limit will be indexed in $500 increments thereafter. For the 3 years immediately preceding retirement, the limit on deferrals under a Section 457 plan will be twice the otherwise applicable dollar limit. The bill also will repeal the rules coordinating the dollar limit on Section 457 plans with contributions under other types of plans. The maximum annual elective deferral to a savings incentive match plan for employees of small employers (SIMPLE) is currently $6,000. H.R. 1836 will increase this limit to $7,000 in 2002 and by $1,000 annual increments thereafter until it reaches $10,000 in 2005. The $10,000 dollar limit will be indexed to inflation in $500 increments.

The bill also will:

- ease some restrictions that apply to loans made by a qualified plan to an owner-employee;
- simplify the definition of a "key employee" and the determination of a plan that is "top-heavy" with respect to benefits for key employees;
- provide that a Section 401(k) plan that meets the "safe-harbor" requirements for minimum contributions on behalf of its participants is not a "top-heavy plan" (i.e., it does not discriminate in favor of highly compensated employees);
- allow matching contributions to be taken into account in satisfying the minimum contribution requirements;
- provide that employees' elective salary deferrals under a qualified plan will not be counted as employer contributions for purposes of the maximum allowable employer deduction for retirement plan expenses;
- increase the limit on deductible contributions under a profit-sharing or stock bonus plan from 15% to 25% of the compensation of the employees covered by the plan;
- provide a nonrefundable tax credit of up to $1,000 for contributions to a qualified retirement plan by individuals with adjusted gross income less than $25,000 and couples with adjusted gross income under $50,000;
- provide small employers with a tax credit of up to 50% of the cost starting a retirement plan, up to a maximum credit of $500, and
- eliminate certain user fees levied by the IRS for determination letters requested during the first 5 plan years with respect to the qualified status of an employer-sponsored retirement plan.

Enhancing Fairness for Women.[1] The bill will permit individuals who are age 50 or older to make additional contributions to a retirement plan authorized under section 401(k), 403(b), or 457 of the tax code. The maximum permitted additional contribution will be $1,000 in 2002, $2,000 in 2003, $3,000 in 2004, $4,000 in 2005, and $5,000 in 2006. This amount will be indexed to inflation in years after 2006. Catch-up contributions to a Section 401(k) plan or similar plan will not be subject to any other contribution limits and will not be taken into account in applying other contribution limits; however, they will be subject to the nondiscrimination rules.

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[1] These provisions are designed to help workers with brief or intermittent work histories.

The bill will increase the limit on annual additions (the sum of employee and employer contributions) under a defined contribution plan from 25% of compensation to 100%, and will conform the limits on contributions to a tax-sheltered annuity to the limits applicable to tax-qualified plans. It also will increase the limitation on deferrals under a Section 457 plan from 33.3% of compensation to 100% of compensation.

Employees are always fully vested in their own contributions to a defined contribution plan, and they must be fully vested in employer matching contributions to such plans in no more than 5 years if the employer uses "cliff" vesting and in no more than 7 years if the employer uses "graded" vesting. H.R. 1836 will accelerate these schedules so that employees will be fully vested in employer matching contributions in a maximum of 3 years under cliff vesting and in no more than 6 years under graded vesting.

The bill directs the Secretary of the Treasury to update the life expectancy tables on which required minimum distributions are based. Distributions from a Section 457 plan made pursuant to a qualified domestic relations order (QDRO) will be made under the same tax rules that now apply to distributions from tax-qualified plans as the result of a QDRO. In addition, a Section 457 plan that makes payments to an alternate payee will not be treated as violating the restrictions on distributions from such plans if such payments were made under a QDRO. The bill also repeals the special minimum distribution rules that now apply to Section 457 plans and makes these plans subject to the minimum distribution rules applicable to §401(k) plans.

Currently, employees are prohibited from making employee contributions and elective contributions for 12 months after pre-retirement "hardship" distributions made to satisfy immediate financial needs. H.R. 1836 will reduce this period to 6 months. Hardship distributions will not be treated as eligible rollover distributions.

Increasing Portability for Participants. The bill will allow eligible distributions from tax-qualified pension plans, §401(k) plans, § 403(b) annuities, IRAs, and §457 deferred compensation plans to be rolled over into any other such plan or arrangement. The rules for tax withholding applicable to rollovers from qualified plans will be extended to distributions from §457 plans. Employee after-tax contributions can be rolled over into another qualified plan or a traditional IRA. In the case of a rollover from a qualified plan to another qualified plan, the rollover will be permitted only through a direct rollover. Surviving spouses will be allowed to roll over distributions to a qualified plan, §403(b) annuity, or §457 plan in which the spouse participates. The bill will allow the Secretary of the Treasury to waive the 60-day rollover period if the failure to waive such requirement would be against equity or good conscience.

Provided that certain requirements are satisfied, a defined contribution plan to which benefits are transferred will not be treated as reducing a participant's accrued benefit if it does not provide all of the forms of distribution that previously were available to the participant. In addition, the Secretary is directed to specify the circumstances under which early retirement benefits, subsidies, or optional forms of benefit may be reduced or eliminated without the rights of participants being materially affected.

Distributions from §401(k) plans, §403(b) annuities, and §457 plans generally can occur without penalty only upon separation from *service* under the particular plan.

Separation from service occurs only with the participant's death, retirement, resignation, or discharge. The bill modifies the distribution restrictions to provide that a distribution may occur upon severance from *employment* with the plan sponsor, including a separation that occur as the result of a merger or acquisition. This effectively repeals the so-called "same-desk rule," which has prohibited pre-retirement distributions to employees whose employer merges with or is acquired by another firm if the employee continues to work at the same job.

A participant in a state or local governmental plan will not be required to include in gross income a direct trustee-to-trustee transfer to a governmental defined benefit plan from a §403(b) annuity or a §457 plan if the transferred amount is used to purchase permissive service credits under the plan or to repay certain contributions.

Under current law, a lump-sum distribution of accrued retirement benefits can be paid to a departing employee without the employee's consent, provided that the present value of the accrued benefit does not exceed $5,000. The participant's written consent is required for such distributions if the value of the distribution exceeds this amount. The bill will allow a plan sponsor to disregard benefits attributable to rollover contributions for purposes determining whether a lump-sum distribution will be greater than $5,000. In the case of involuntary distributions of $1,000 or more, the bill makes direct rollover to an IRA the required method of distribution unless the participant directs otherwise.

Strengthening Pension Security and Enforcement. Under current law, the "full funding limit" for tax-qualified plans is 150% of the plan's accrued liability. The bill raises this limit to 165% of current liability for plan years beginning in 2002 and to 170% for plan years beginning in 2003. The current-liability full-funding limit is repealed for plan years beginning in 2004 and thereafter. The special rule allowing a deduction for unfunded current liability generally is extended to all defined benefit pension plans covered by the Pension Benefit Guaranty Corporation (PBGC). In determining the amount of pension contributions that are not deductible, an employer will be permitted to disregard contributions to a defined benefit plan except to the extent that they exceed the accrued-liability full-funding limit. If an employer so elects, contributions in excess of the current-liability full-funding limit will not be subject to the excise tax on nondeductible contributions.

Because pension benefits under multi-employer plans are generally based on factors other than compensation – such as a flat benefit per month of service – the limits on benefits provided for under §415 of the tax code can result in significant benefit reductions for workers who are covered by these plans and whose compensation varies from year to year. The bill eliminates the cap on benefits (equal to 100% of compensation) for multi-employer plans and provides that multi-employer plans are not to be aggregated with single employer plans for purposes of applying the 100%-of-compensation cap to those plans. The bill also clarifies the method of determining the tax year to which an employer contribution to a multi-employer plan is attributable.

Section 1534(b) of the *Taxpayer Relief Act of 1997* (P.L. 105-34) prohibits the sponsor of a §401(k) plans from requiring part of an employee's elective deferrals to be invested in the employer's securities or property. H.R. 1836 clarifies that §1534(b) does not apply if these assets were acquired as the result of deferrals made before 1999.

The bill requires an excise tax to be levied on an employee stock ownership plan (ESOP) engaging in prohibited transactions with "disqualified individuals" deemed to be substantial shareholders of the corporation sponsoring the plan.

The sponsors of defined benefit plans will be required to notify plan participants in advance of any amendment that would significantly reduce the rate of future benefit accruals. (Such reductions in accrual rates sometimes occur, for example, when a traditional pension is converted to a *cash balance* plan). A plan amendment that reduces or eliminates an early retirement benefit or retirement-type subsidy will be considered as reducing the rate of benefit accrual. The notice must include sufficient information to allow participants to understand the effect of the amendment. An excise tax will be levied against the plan sponsor if the required notice is not provided. The Secretary of the Treasury will be authorized to allow simplified forms of notification, or to exempt from the notification requirement, plans with fewer than 100 participants and plans that allow participants to choose between the old and new plan benefit formulas. The Secretary is required to report to Congress on the effect of cash balance conversions on participants' pension benefits, with special reference to periods during which no new benefits are accrued (so-called "wear-away" periods).

Reducing Regulatory Burdens. A defined benefit plan with assets equal to at least 125% of current liability will be permitted to use a valuation date within the prior plan year. An employer will be entitled to deduct dividends that, at the election of plan participants or their beneficiaries, are paid to the plan and reinvested in employer securities. The special definition of a "highly compensated employee" under the *Tax Reform Act of 1986* is repealed.

The bill directs the Treasury Department to revise its regulations under §410(b) to provide that, if certain requirements are satisfied, employees of a tax-exempt charitable organization who are eligible to make salary reduction contributions under a §403(b) annuity may be excluded for purposes of testing a §401(k) plan for nondiscrimination in favor of highly compensated employees. Qualified retirement planning services provided to an employee and his or her spouse by an employer maintaining a qualified plan generally will be excluded from employee income.

Under current law, elective deferrals under a §401(k) plan are tested for discrimination in favor of highly compensated employees by means of the actual deferral percentage test ("ADP test") and the actual contribution percentage test ("ACP test"). Under certain circumstances, the Treasury Department may subject a plan's elective deferrals, employer matching contributions, and after-tax employee contributions to an additional nondiscrimination test, called the "multiple use test." The bill repeals the multiple use test.

Tax treatment of electing Alaska Native Settlement Trusts. In order to encourage Alaska Native Settlement Corporations to establish Settlement Trusts, the bill allows an election under which special rules will apply in determining the income tax treatment of a Trust and its beneficiaries.