

Federal Update 2004-1

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TO: NCTR Members

FROM: Cindie Moore, Washington Counsel

RE: Outlook in 2004 for Congressional Activity Affecting NCTR Members

Introduction

Congress returned to Washington January 20 for a short session because of the fall presidential election. The Republicans and Democrats are each holding a convention this summer to nominate their respective presidential candidate. The conventions dictate a longer summer congressional break than usual. In addition, both House and Senate leaders have announced an October 1 adjournment to give members a month to campaign before Election Day, which falls on November 2. The longer summer break and the shorter fall schedule mean that Congress has very little time to pass legislation. Let's run down the issues affecting state and local government (SLG) retirement systems and assess their chances of enactment.

Administration's Savings Proposal

The Administration proposed a dramatic savings proposal in 2003. Although it did not move, the likelihood of a similar proposal re-surfacing in the President's Fiscal Year 2005 Budget is very high. The Administration has scheduled a February 2 release of the Budget.

As drafted in 2003, the savings proposal has two parts. Part One is the creation of two savings accounts: Lifetime Savings Accounts (LSAs) for any type of savings and Retirement Savings Accounts (RSAs) for retirement savings. Savers would contribute funds into the accounts on an after-tax basis. For LSAs, earnings on the accounts and withdrawals would be tax-free. They could be used for any purpose. For RSAs, the tax-free treatment is the same except that the saver must wait until age 58 to withdraw them without penalty. Savers could contribute up to \$7,500 annually to an LSA and an equal amount per year into an RSA.

Part Two of proposal is the consolidation of 401(k)s, 403(b)s, 457s, and other types of employer-sponsored defined contribution plans into a single plan called an Employer Retirement Savings Account (ERSA). Any type of employer could offer an ERSA, as opposed to the current situation in which, for example, 403(b)s may be offered by educational and certain tax-exempt entities only. The ERSAs would follow the existing rules for 401(k) plans, but in a simplified fashion.

The proposal received a mixed reaction last year. Banks and mutual fund companies, which would offer RSAs and LSAs, supported them. The life insurance

industry and managers of pension plans feared losing business if investors shift more money into savings accounts. Sen. Grassley says he's neutral on the proposal. Rep. Rob Portman (R-OH), a House pension champion, raised concerns about LSAs. He says that long-term, not short-term savings should be encouraged. The President was expected to announce the proposal in the State of the Union address. He did not (although he mentioned Social Security privatization, as noted elsewhere). This year's version of the proposal may be in a slightly scaled back form.

Representatives of SLGs retirement plans are concerned about the impact of the proposal, especially ERSAs. Concerns include:

- Eliminating favorable treatment for governmental 403(b)s and 457s, such as exemption from the nondiscrimination rules, special catch up rules, and exemption for 457s from the 10% penalty tax;

- Blurring the well-established line between federal regulation of 403(b) and 457s and state and local government regulation of them; and

- Possible application of ERISA if the investor advice rules applicable to 401(k)s are applied to ERSAs.

Representative Sam Johnson (R-TX) is expected to offer legislation in support of the administration's effort fairly soon. Congressional sources expect there to be pressure on House members, particularly Ways and Means Committee members, to line up behind the proposal early. Representatives of SLG plans will be meeting with Members of Congress about their concerns. Although it is difficult to imagine such a dramatic proposal passing in an election year, it will likely trigger extensive debate.

Social Security Anti-Fraud Bill (H.R. 743) and Pension Legislation (NESTEG/H.R. 1776) Pending at End of 2003

Two bills received action during fall 2003 that directly affect SLGs and their retirement systems: H.R. 743, a Social Security anti-fraud bill, and the National Employee Savings and Trust Equity Guarantee (NESTEG) Act (no bill number yet).

H.R. 743 affects SLGs and their retirement systems in three ways. First, it requires a SLG employer hiring an individual for a non-Social Security covered position to provide him/her with a written notice. The notice explains the effect of non-Social Security covered work on any separate Social Security covered work by the individual. In other words, the benefit from the Social Security covered work might be reduced by the non-Social Security covered work. The individual must sign the notice before starting work. The employer must send the signed notice to the relevant retirement system. In an earlier version of H.R. 743, retirement systems were to have reported via the 1099R whether a pension was based on non-Social Security covered service. That provision was dropped in favor of the notice requirement.

Second, H.R. 743 allows Kentucky and Louisiana to have a divided retirement system. Under such a system, employees choose whether to be in Social Security or not, provided that new hires are covered by Social Security. Both states requested the change.

Third, H.R. 743 extends the “last day” rule that determines whether someone is subject to the Government Pension Offset (GPO). The GPO may reduce or eliminate an individual’s spouse benefit from Social Security if the individual receives a pension from non-Social Security covered work. Under current law, if someone is in a position not covered by Social Security, but moves just prior to retirement to a Social Security covered position and the position is covered by the retirement system that will provide him/her a pension, he/she is exempt from the GPO. H.R. 743 extends the time to qualify for the exemption from one day to 60 months. A transition rule is included to mitigate the effect of the change.

While H.R. 743 relates to Social Security, NESTEG is a pension bill. It includes the following items in the nature of governmental plan clean up provisions. First, NESTEG makes clear that IRS should broadly interpret the “nonqualified” service credit purchase provisions of IRC § 415(n).

Second, NESTEG would allow SLG retirement systems to be deemed as having complied with the minimum distribution rules of IRC § 401(a)(9) if they follow a reasonable good faith interpretation. The provision would resolve the current issue in which Treasury, through temporary rules, made flat percentage and other types of Cost of Living Adjustments (COLAs) of SLG retirement systems impermissible. Treasury has delayed the effective date of the temporary rules until further notice.

Third, NESTEG would allow defined benefit plans to accept after-tax rollovers, if they so wished and could separately track the after-tax funds from the pre-tax funds. At present, defined contribution plans may accept these types of rollovers. Allowing defined benefit plans to do so would expand portability.

Fourth, NESTEG would exempt from the 10% early withdrawal tax any distributions from a governmental defined benefit plan to a qualified public safety employee who separates from service after age 50.

The Senate unanimously passed H.R. 743 December 9. Key House sources want to pass the Senate version in their respective chamber early in the session and send it to the President for his signature. NESTEG is a different story. What the Senate Finance Committee passed on September 17 has still not been drafted (hence, no bill number, as noted above). Although the governmental plan clean up items are not controversial, several other issues make NESTEG problematic. Most significantly is the need to replace the 30-year Treasury bond rate formerly used in calculating contributions for private pension plans. A temporary fix expired at the end of last year, making the issue a “must do” item. If Congress does not act by April, companies with defined benefit plans will be required to make very large contributions to their plans. Divergent industries have been promoting various solutions. It appears that a resolution is close, however,

because Senate leaders have agreed to take up H.R. 3108, a House-passed bill dealing with the issue in the next few weeks. Assuming this scenario takes place, the issue moves out of NESTEG and into another vehicle. Thus, the “must do” issue in NESTEG disappears and the governmental plan clean up items are left in a bill of lower priority.

The outlook for H.R. 1776, the House version of NESTEG is equally uncertain. It passed the Ways and Means Committee July 18 in a rancorous atmosphere during which the Capitol Hill police were called. Because of the controversy surrounding the House version of the bill, it’s unlikely that either NESTEG or H.R. 1776 will pass this year. (For further information about H.R. 743, NESTEG, or H.R. 1776, click onto the Federal Developments button of www.nctr.org.)

Social Security Reform – Campaign Issue for 2004

H.R. 743 and the governmental plan clean up items are low profile issues. Broader issues such as Social Security reform will attract interest in 2004.

According to the Social Security Administration, the system’s trust fund will be exhausted in 2042 and Social Security benefits will be cut unless some action is taken. The President briefly mentioned the privatization of Social Security January 20 during his State of the Union address. He called for the creation of private accounts in which workers would invest part of their payroll taxes. The funds in the accounts would pay a portion of the Social Security benefits. In their response to the President’s comments, the Democratic leaders opposed privatization, saying that Social Security should be a “guarantee, not a gamble.”

These divergent views make Social Security an issue ripe for campaign rhetoric, not bipartisan consensus. Senator Charles Grassley (R-IA), the Chairman of the Finance Committee, which has jurisdiction over Social Security issues, says the earliest that Congress would tackle the issue is 2005.